PART 2: NPO-specific financial reporting issues

INTERNATIONAL FINANCIAL REPORTING
FOR NON PROFIT ORGANISATIONS

Overview

Overview

1. Relationship with Part 1 of the Consultation Paper

1.1 Part 1 of this Consultation Paper discusses the broader NPO financial reporting landscape and considers this in the context of the project objectives set out in the Introduction. Part 1 includes a description of the broad characteristics of NPOs. It considers accountability and decision making and the role that general purpose financial reports can play in providing decision useful information for external stakeholders. Finally, it looks at the suitability of existing international and national financial reporting regimes as the basis of future NPO Guidance.

1.2 Part 2 of this Consultation Paper considers a number of NPO-specific financial reporting issues. It raises questions that are relevant to the project objectives, such as balancing the needs of preparers and users and improving the transparency of NPO financial reports. However, the main focus is to assist in delivering the third project objective:

> **Objective 3:** To address specific NPO issues, which will promote the comparability of NPO financial reports.

1.3 Part 2 is written for those interested in the technical accounting considerations of NPO-specific issues. The language is necessarily more technical in nature than in Part 1, with the main terms explained in the Consultation Paper Glossary. These terms are not intended to be used as definitions, with many having specific meanings in different jurisdictions and in national and international accounting and other professional frameworks. Definitions will be developed as part of the Exposure Draft.

1.4 This part of the Consultation Paper sets out how the list of NPO-specific financial reporting issues for potential consideration was originally identified and provides a description of the nature of each issue. The criteria used for selecting the issues to be included in the Consultation Paper, and therefore probably in the initial Guidance, are also included.

1.5 Analysis is provided for each of the NPO-specific financial reporting issues currently proposed for the initial Guidance. Alternative approaches that could be pursued to address each issue are included to generate feedback. These alternatives are consistent with the proposed Guidance model in Part 1: Chapter 5.

2. Identification and Selection of NPO-specific financial reporting issues

2.1 Reporting issues for NPOs have been subject to much debate globally for many years. They have been reported:

- in academic studies
- by standard setters
- by stakeholders and members of the NPO community, including donors.

2.2 The project team has compiled a list of NPO-specific issues from these sources. The types of issues identified may be grouped under the five broad categories in Figure 2.1:

Figure 2.1: NPO financial reporting issue categories[20]

[20] Issues have come from the CCAB report (2014), the ACCA Companion Guide (2015), the IFASS Working Group and from Advisory Group members. For further information see Supplementary Information: Additional project information.

2.3 Non-exchange transactions, which include donations, grants and volunteer services, feature heavily in the list. These transactions are characterised by situations where the provider of the resources does not themselves directly receive goods and/or services of approximately equal value in return for the resource they provided.

2.4 The description of each issue has been developed, with input from the project advisory groups,[21] to contextualise the nature of each issue. The list is intended to only include issues that are specific to NPOs. It is not intended to cover financial reporting issues of a more general nature that are also relevant to the public sector and private sectors. It is important that the list of issues is complete to create a framework for the work to be carried out over this and subsequent phases of the project.

2.5 In this initial phase of the project, it will not be possible for every NPO-specific issue to be addressed because of time and resource constraints. Prioritisation will therefore be necessary to focus efforts on the issues that will have the most significant impact, helping to deliver the project objectives and in doing so, the potential to add greatest value to NPOs.

2.6 Four criteria have been developed for evaluating the relative priority of each issue as set out in Figure 2.2. These criteria have been used to assess the issues in Table 2.1 Priority issues and in Table 2.2 Issues to be considered in later phases.

2.7 To summarise, the topics proposed for inclusion in the Guidance will be those NPO-specific issues that have been evaluated to have potential to provide the best outcome **across all four criteria**. This might mean that an issue is not included if it only features highly against one of the criteria. For example, feasibility on its own may not be sufficient for an issue to be prioritised.

2.8 Table 2.1 shows the list of the NPO-specific financial reporting issues that were prioritised for inclusion in the Consultation Paper after evaluation using these criteria. Table 2.2 provides a list of topics that could be considered in the future. Further background on these topics is provided in Annex A.

[21] For further information about the project advisory groups see Supplementary Information: Additional project information.

Figure 2.2: Criteria for NPO-specific issue prioritisation

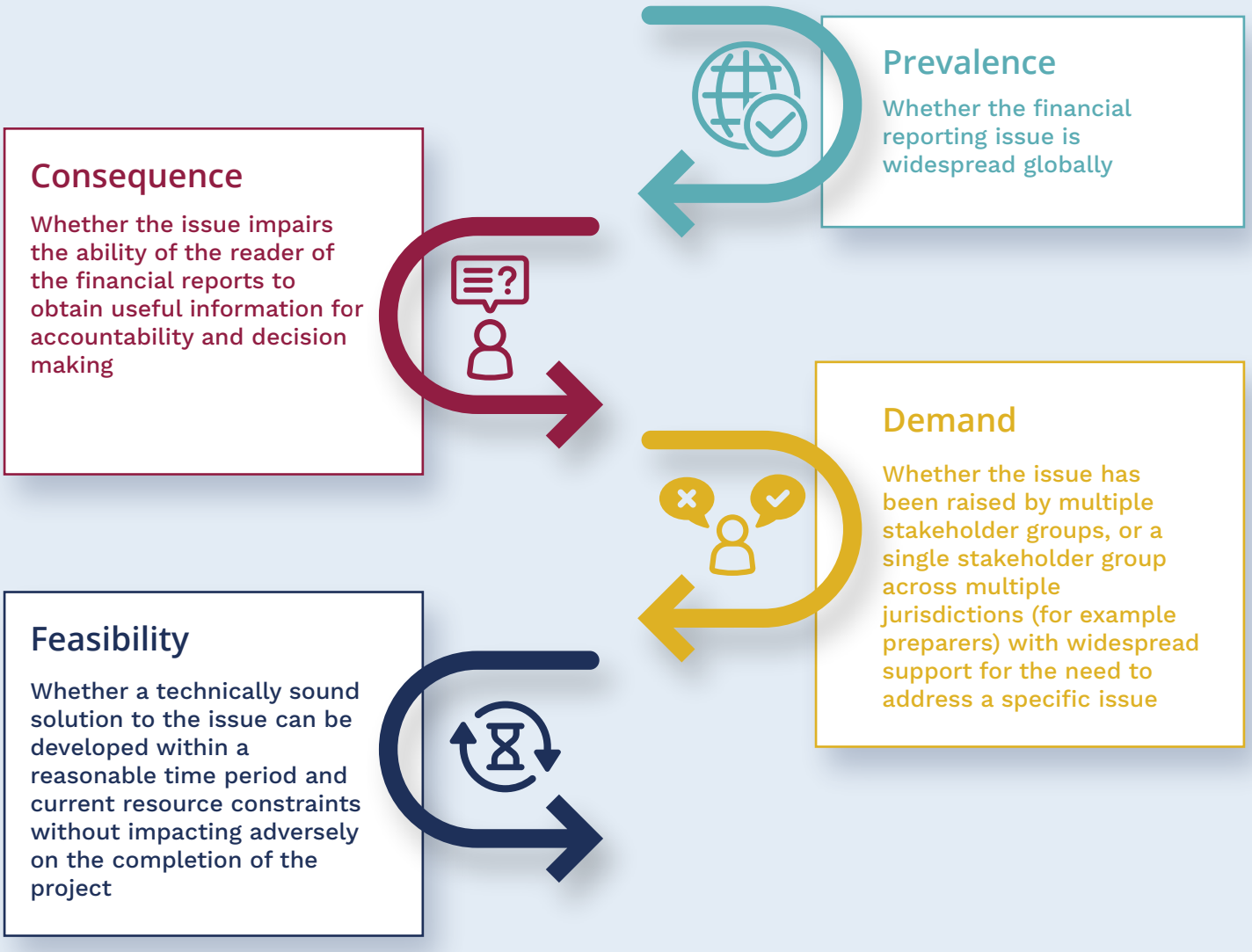
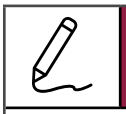


Table 2.1: NPO-specific financial reporting issues prioritised for the Consultation Paper

No	Topic	Page
	Reporting entity	
1	Reporting entity and control (including branches)	77
2	Acting on behalf of another entity	87
	Accounting for incoming resources	
3	Revenue: Recognition and measurement of incoming resources from external sources, including cash contributions, gifts in-kind and services in-kind	98
	Accounting for outgoing resources	
4	Grant expenses	117
	Accounting for non-financial assets	
5	Measurement of tangible and intangible assets held for social benefit	126
6	Inventory held for use or distribution	138
	Presentation, content and scope of Financial Reports	
7	Financial statement presentation	151
8	Classification of expenses – function or nature	161
9	Fundraising costs	170
10	Non-financial reporting (including service reporting)	178

Table 2.2: NPO-specific financial reporting issues to be considered in later project phases

No	Topic
	Reporting Entity
11	Mergers and acquisitions (combinations)
12	Intragroup transactions
	Accounting for incoming resources
13	Recognition of legacy/bequest income and endowments
	Accounting for non-financial assets
14	Heritage assets and/or obligations
15	Concessionary loans for social purposes
16	Concessionary leases
17	Accounting for investment/financial assets
18	Service concessions arising in NPOs as grantor
19	Service concessions arising in NPOs as operator
	Presentation, content and scope of financial reports
20	Related party transactions
21	Remuneration/pay disclosures
22	Foreign currency transactions



Specific Matters for Comment 0

0.a Is the list of NPO-specific financial reporting issues complete? If not, please provide information about the further issues that you believe are specific to NPOs, or issues that should be removed, together with supporting reasoning for the change(s) you propose.

0.b Do you agree with the criteria used to evaluate the list of issues? If not, what changes would you make and why?

0.c Do you agree with the topics prioritised for the Consultation Paper? If not, outline which topics should be added or removed and why.

2.9 Additions to the list of issues will only be made for issues that are NPO-specific. Issues added to the list will be evaluated against the criteria to determine whether they should be considered in the initial phase of the project, or in a subsequent phase. Re-prioritisation of issues to be included in the initial phase may be required to ensure that it is feasible to deliver the Guidance within the project timeline.

3. Issue papers

3.1 Sections 1-5 of this part of the Consultation Paper contain a discussion of a series of issues that provide a more in-depth look at the NPO-specific financial reporting topics prioritised for consideration as listed in Table 2.1. They seek to engage with potential users on each issue, particularly to confirm the understanding of the issue and obtain feedback on alternative ways forward. This feedback is critical ahead of detailed technical development, which will take place in the next stage of the project ie, developing the Exposure Draft.

3.2 The papers do not include regulatory issues such as impacts on tax or impacts on audit thresholds that might arise from the alternatives, which are likely to be jurisdiction specific. These are areas on which feedback is encouraged through the specific matters for comment identified for each issue.

3.3 The issue papers provide information about existing international financial reporting guidance, and also give examples of how issues have been addressed in some national guidance. These guidance sources have provided the building blocks for the alternative approaches that have been developed for each of the issues.

3.4 Not all topics have the same number of alternatives, and the alternatives considered are topic specific. All issue papers include at least one alternative that is a tailored solution consistent with the Guidance model proposed in Part 1: Chapter 5.

3.5 Examples of the accounting treatments that might result from each of the alternatives are not provided in this Consultation Paper given the early stage of development. There is, however, a description of potential advantages and disadvantages to indicate the expected impacts. No weighting has been given to these potential impacts, but the likelihood is that some will be more significant to respondents than others. To standardise the presentation of the advantages and disadvantages, the analysis considers:

- **Technical points** – for example, level of consistency likely with international standards, whether an alternative might improve a technical aspect or creates a new technical issue.
- **Practical points** – the extent to which the alternative might make it easier or more difficult for NPOs to prepare their financial reports.
- **Stakeholder perspectives** – the potential benefits for users of the accounts, or potential barriers for preparers, usually expressed with reference to understandability, comparability and transparency.
- **Cost/benefit considerations** – the potential impact on costs and where appropriate how these relate to potential benefits.

3.6 The issues papers do not include a preference for any alternative. However, a few alternatives may have less technical merit. Such alternatives have been included because of the perceived pragmatic benefits of a proposal.

3.7 Each issue paper follows the same format as set out in Figure 3.1.

Figure 3.1 Issue paper structure

Description of the issue – an overview with examples to illustrate the nature of the problem. Clarity about the nature of each issue is important to identifying the financial reporting challenges.

Financial reporting challenges – these set out the issues, which are usually concerned with recognition, measurement, presentation or disclosure of informtion.

International and national guidance – including the requirements of those standards and whether the standards meet the challenges fully, in part or not at all. Also shows how international standards have been used in jurisdiction specific guidance.

Alternative approaches to address the issue – are provided with advantages and disadvantages grouped under 4 four headings; technical, practical, stakeholder and cost/benefit. This is to identify potential impacts on the preparation and quality of the financial statements.

3.8 Each issue paper is supported by supplementary information gathered from a number of jurisdictions, predominantly those that have specific guidance for the non-profit sector. This illustrates various treatments adopted around the world and provides details of the location of the national guidance where this is in the public domain. This information can be found in the Supplementary Information section: International and national financial reporting standards and guidance for NPOs.

4. Responding to the Consultation Paper

4.1 Each issue paper has Specific Matters for Comment (SMCs), which are in addition to the questions contained in this overview. Each issue paper invites responses to a standard set of SMCs and may, by exception, include additional questions. These standard questions focus on the description of the issue and the alternatives.

4.2 Respondents are invited to express a preference from the alternatives provided or put forward further alternatives with the rationale for the response provided. Alternatives that gain the greatest support through this consultation paper will be prioritised for further development as part of the Exposure Draft.

4.3 Responses may be made to any of the matters raised and there is no need to respond to them all. However, the evidence base to support the development of the Exposure Draft will be improved if more comments are received. Respondents are therefore encouraged to respond to as many SMCs as relevant.

4.4 Additional matters can be raised in responses, where these are not covered by the SMCs. Section 6 of the Introduction provides further information about how to respond to this Consultation Paper.

Annex A

Background on issues that are not included in Sections 1-5[22]

Topic	Issues
Reporting entity	
Mergers and acquisitions (combinations)	What is the accounting treatment for the combination of two or more NPOs? Should merger accounting be permitted/required? If the acquisition method is required what is the accounting for a gain/negative goodwill?
Intragroup transactions	When is income from a subsidiary recognised in the parent NPO's accounts, taking account of legal considerations relating to the way in which the profits of a subsidiary are given to a parent? What disclosure should be required by both sides of the relationship/transaction when a branch is part of a larger NPO or an NPO is part of a group?
Accounting for incoming resources	
Recognition of legacy/ bequest income and endowments	When should bequests be recognised? What are the considerations involved with perpetual trusts and/or a portfolio of similar smaller assets? How are endowments recognised and classified, including the treatment of the initial contribution, subsequent changes in the value of the initial contribution and treatment of income earned? How should income from endowments be presented in the Statement of Financial Performance and Statement of Financial Position (balance sheet)? What disclosures should be required for any restrictions on the entity?
Accounting for financial and non-financial assets	
Heritage assets and/or obligations	Recognition and measurement of heritage assets. What disclosures should be made about the nature and scale of heritage assets and acquisition, preservation etc. of the collection? Recognition and measurement of significant heritage obligations, and any impact on the measurement of related assets.
Concessionary loans for social purposes	What is the definition of a concessionary loan? What is the initial and subsequent measurement of special credit conditions? What is the treatment within a group if there is an inter-company loan with a for-profit entity? What disclosures should be made?
Concessionary leases	How should such arrangements be accounted for?
Accounting for investment/ financial assets	Classification, recognition and measurement requirements.
Service concessions arising in NPOs as grantor	When do these arise in the non-profit sector eg low income housing? What disclosures are required?
Service concessions arising in NPOs as operator	When do these arise in the non-profit sector eg low income housing? What disclosures are required?
Presentation, scope and content of financial reports	
Related party transactions	Definition and required disclosures of related party transactions. Implications of local legal requirements?
Remuneration/pay disclosures	What disclosures should be made and who should be included? The relationship with related party disclosures?
Foreign currency transactions	Whilst there are no sector specific issues with accounting for foreign currency transactions, how should requirements by donors that a particular exchange rate is used for specific transactions be addressed in financial reporting? Where should foreign exchange gains and losses be presented on the Financial Reporting Statement? How is consistency of reporting achieved?

[22] Issues were not included based on the discussions in paragraphs 2.5-2.8.

Section 1: Reporting entity

Section 1: Reporting entity

NPOs can be organised in a variety of different ways, using internal structures focused on specific activities, through subsidiaries, partnerships or other types of arrangements. As a consequence, issues have been raised about what is a reporting entity and how to account for entities that are part of a group. These focus on what defines a reporting entity and when does one entity control another. Given the focus on control this section also considers how to account for transactions that an NPO is carrying out on behalf of another entity. Other NPO-specific consolidation issues are not proposed to be included in the initial Guidance.

Issue 1 – Reporting entity and control (including branches)

Reporting entities need to produce financial statements and so it is important to know what constitutes a reporting entity in the sometimes complex arrangements that surround NPOs. Understanding the accounting implications of these arrangements is key to providing complete and transparent financial information.

Some of the specific questions that this topic is seeking to address are:

- How is control defined (as NPOs may not be exposed to investee returns in a conventional sense)?
- How is a branch defined? Should all branches be accounted for as part of an NPO? What is the status of the financial statements of a branch that is not a separate legal entity?

Issue 2 – NPOs acting on behalf of other entities.

The complex arrangements that surround NPOs may mean that in some instances an NPO is acting on behalf of another entity. It can be difficult to determine whether an NPO is merely acting in an administrative role and its accountabilities.

Some of the specific questions that this topic is seeking to address are:

- When is an NPO acting as an agent and when is it acting as principal?
- Is any disclosure required of the gross amounts relating to agency activity or assets in custody (including cost pass through and assets held on behalf of another entity/person)?

Issue 1: Reporting entity and control (including branches)

1. Description of the issue

1.1 **Transparency improves comparability between similar types of NPOs that have different operating structures**. Full transparency and accountability over the assets and liabilities of NPOs is critical to financial reporting. Users need to know which activities are part of the reporting entity and the critical relationships with other entities.

1.2 **NPOs may have complex organisation structures to deliver their objectives**. NPOs often operate across multiple geographical areas. NPOs can supply a similar service to different areas of the same jurisdiction, or on an international basis, supply services to other jurisdictions. Activities that take place across a range of locations may be organised through a series of separate offices. Alternatively, assets, staff and/or resources may be formally allocated to a specific activity within an entity.

1.3 **Activities may not be delivered through a common model.** Activities may be delivered through separate legal entities or in partnership with another entity. Also, service recipients or supporters of an NPO may form entities to partner with and/or support an NPO.

1.4 **Many NPOs operate through a system of 'branches'**, with a branch being an internal structure created to carry out activities. Branches are part of an NPO's operating structure and may be established to provide specific arrangements in a locality. They may also be used for fundraising. Branches may have their own bank accounts, with funds raised for specific local projects.

1.5 **NPOs can appear similar to the public but require different financial reporting arrangements**. NPOs may have service arrangements with local offices that are separate reporting areas, within an NPO. These reporting areas could have their own differing financial reporting arrangements. NPOs could also have service arrangements with other entities controlled by an NPO and insist on uniform activities and financial arrangements consistent with an NPO's central requirements. A range of examples include a local organisation affiliating with an NPO's national brand to benefit from logos, insurance etc, but maintaining its own financial and governance arrangements. Recognising these local organisations as a reporting entity can help internal decision-making in respect of assets and liabilities (ie resources and potential risks).

1.6 **NPOs can face practical issues in producing their financial statements.** For example, an NPO may experience resistance to controls over local organisations (including branches) provided by legal powers. Branches may resist requests by an NPO and not submit financial returns or provide other information. Enforcement activities may not be worthwhile where individual branches are immaterial to the parent NPO's accounts.

1.7 **Determining whether an activity or branch is a separate reporting entity is often not easy.** The nature and complexities of the relationships that exist may make it challenging to decide when an activity or branch is part of an NPO, when it is part of a separate standalone reporting entity, or when it is part of a separate reporting entity controlled by an NPO.

1.8 **Branches might not publicly report anywhere in the world** because they are not included in any financial reports. This might occur where a branch is not included, for example, in the accounts of its international based headquarters organisation and is also not considered a reporting entity in the jurisdiction that it is operating.

1.9 **Having trustees that are common across NPOs might raise questions about the relationship between NPOs**. This might occur where two NPOs with different operations have common trustees or a significant overlap in trustees. There are also questions where trustees have the ability to appoint trustees or board members in other related entities.

2. Financial reporting challenges

2.1 **NPOs need to follow the requirements of local regulators**. This may influence the way in which reporting entities are identified and subsequently treated in an NPO's financial reports.

2.2 **Different regulatory frameworks can exist within national jurisdictions** for different types of NPOs as well as between them. For example, a UK charity registered as a company follows requirements specified by the Companies Act 2006 while a social enterprise charity will follow the Charities Statement of Recommended Practice (SORP). The different frameworks may lead to different financial reporting outcomes for similar activities (although arguably in the UK these regulatory frameworks will lead to similar results for the majority of cases).

2.3 **NPOs may require substantial information and analysis to make judgements about control.** Determining the degree of control sufficient to recognise the assets and liabilities (and other resources) of a separate activity or reporting entity in the financial statements of an NPO may be challenging because of the nature of the relationships.

2.4 **There may be severe long-term restrictions that hinder control**. In some situations, the ability of one NPO to exercise rights over another may be limited. Alternatively, an entity may be held exclusively with a view to its subsequent resale. The identification of severe long-term restrictions requires a highly subjective assessment and may fluctuate wildly over relatively short periods of time.

2.5 **The definition of a reporting entity needs to be consistently applied**. There is a challenge in deriving definition of a reporting entity suitable for NPOs so that users get comparable information. The definition needs to be workable regardless of the way in which an NPO decides to operate. NPOs will need to ensure that decisions relating to control are consistent.

2.6 **Without additional disclosures it may not be clear what is included** as part of an NPO (ie which, if any, branches are included) and which entities are controlled and form part of an NPO's financial statements. The challenge involves the need to provide transparency, including the judgements being made to foster users' understanding of the reporting entity and the ability to assess comparability with other NPOs.

3. Current international guidance

3.1 Currently international guidance on the reporting entity and control relationships between entities is provided in:

- IFRS Foundation Conceptual Framework[23] – Reporting Entity chapter
- IPSASB's Conceptual Framework[24] – Reporting Entity chapter
- IFRS 10 *Consolidated Financial Statements*
- Section 9 of the *IFRS for SMEs* Standard
- IPSAS 35 *Consolidated Financial Statements.*

Reporting entity definition

3.2 The International Accounting Standards Board (IASB) and IPSASB conceptual frameworks include very similar definitions of reporting entities. The IASB states that a reporting entity is an entity that is required, or chooses, to prepare financial statements. The IPSASB definition establishes that a reporting entity is a government or other public sector organisation that produces general purpose financial statements. They both confirm that reporting entities need not be legal entities.

3.3 Both definitions recognise the role that control can play in the definition of a reporting entity, ie that it can be more than one organisation and that the reporting entity can be parent of a group.

[23] IFRS Foundation Conceptual Framework for Financial Reporting.
[24] IPSASB's Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities.

Definition of control

3.4 The definition of control in IFRS 10 *Consolidated Financial Statements* focuses on the substance of transactions and not their legal form. The key principle in IFRS 10 is that an investor controls an investee, if and only if, the investor has:

- power over the investee
- exposure, or rights, to variable returns from its involvement with the investee
- the ability to use its power over the investee to affect the amount of the investor's returns.

3.5 IPSAS 35 is largely aligned with IFRS 10 and uses the same definition of control but includes a number of amendments to reflect public sector circumstances. Those relevant include:

- removal of references to 'investor'
- use of the term 'benefits' instead of 'returns'
- modification to highlight the range of relevant activities that could occur in the public sector
- clarification that regulatory control and economic dependence do not give rise to power for the purposes of the standard(s).

3.6 Both IFRS 10 and IPSAS 35 state that to have power over another entity, an entity must have existing rights that give it the current ability to direct the relevant activities. The relevant activities are those activities that significantly affect the nature or amount of the benefits from its involvement with the other entity.

3.7 The definition of control in the *IFRS for SMEs* Standard is aligned with the principles-based definition of control from the superseded version of IAS 27 *Consolidated and Separate Financial Statements*. Control is defined as the power to govern the financial and operating policies of an entity to obtain benefits from its activities. The *IFRS for SMEs* Standard uses a different (and narrower) definition of control which is supported by provisions that are more pragmatic.

3.8 Under the *IFRS for SMEs* Standard control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity. The standard states that this presumption may be overcome in exceptional circumstances if it can be clearly demonstrated that such ownership does not constitute control.

4. National-level guidance[25]

4.1 In national level guidance gathered there are essentially two approaches being taken that reflect the international standards available. Some jurisdictions

[25] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

follow the international standards for the private and public sectors and require NPOs to determine control based on principles that relate to the substance of the relationship between entities, supported by additional guidance specific to NPOs.

4.2 In other jurisdictions there is a closer relationship to the *IFRS for SMEs* Standard. In these jurisdictions, although there is a principles-based definition of control, it is narrower, and the focus of the supporting provisions is on the voting or operational control of the entity. Guidance is also provided about the sets of circumstances that would suggest control.

4.3 In addition, some jurisdictions have provided additional guidance about branches. In one jurisdiction there is specific guidance about branches which it notes include special trusts, linked or connected charities and certain joint ventures of charities but that do not involve a separate joint venture. Branches are deemed to be the legal property of a charity and reflect a charity's administrative arrangements whereby its internal operating structure is arranged according to function, location or other factor designed to facilitate its administration.

4.4 Another jurisdiction provides indicators that an organisation may be a branch and/or whether a branch is a separate reporting entity. The indicators that an organisation may be a branch can relate to the branding of the organisation (naming, registrations, websites) and financial support.

5. Alternative financial reporting treatments

5.1 NPOs can have unique types of arrangements both within and between different types of entities. There is some national level guidance specific to such arrangements, but no international guidance. Both alternative approaches proposed are built on the basis that NPO-specific guidance is developed to address these types of arrangement, including 'branches' which are common within the sector. The addition of NPO-specific guidance as part of both alternatives will provide the potential to improve the transparency over the scope of an NPO's activities.

5.2 **Alternative 1** is based on the preparation of this additional NPO-specific guidance, using a principles-based approach to determine whether one entity has control over another. This alternative uses the substance over form principles included in IFRS Standards and IPSAS (IFRS 10 and IPSAS 35).

5.3 The control models under IFRS Standards and IPSAS both include substantial reporting requirements (a separate standard) to present an entity's interests in other entities. Additional guidance is proposed to explain how the principles should be applied and appropriate disclosures. Disclosures would be focused

to provide appropriate information to understand the structure, risks and impacts of any branches operating within an NPO and related to other entities.

5.4 **Alternative 2** proposes the use of pragmatic methods of assessment such as the power to govern financial and operating policies to define control as required by the *IFRS for SMEs* Standard[26]. This alternative would focus on key characteristics that define NPO relationships and use the control principles set out in IFRS 10 and IPSAS 35 to develop tests to determine control. This may be a more pragmatic approach, particularly for smaller NPOs than a potentially more resource intensive assessment using principles.

5.5 The alternatives proposed do not address consolidation issues or where a branch might be an associate or joint venture and only goes to what is a reporting entity and where they sit from a control perspective in a reporting structure. Consolidation will be addressed as a separate topic and is not proposed for inclusion in this first phase of the IFR4NPOs project.

[26] The International Accounting Standards Board has initiated a programme to review the *IFRS for SMEs* Standard and in particular to consider updates for standards issued since the last update. This will include IFRS 10 *Consolidated Financial Statements*.

	Description	Advantages	Disadvantages

Alternative 1
Prepare additional NPO-specific guidance on the nature of reporting entities and use the principles-based approach of substance over form to define control.
	• Prepare additional NPO-specific guidance about how to identify a reporting entity including branches.
	• To determine control, use the three principles:
	  • power over the entity
	  • exposure, or rights, to variable returns/benefits from its involvement with the other entity
	  • the ability to use its power over the other entity to vary the returns/benefits.
	• Provide additional guidance on how to apply the principles for NPOs including how to specify relevant activities, ie those activities that significantly affect returns on a public benefits basis.
	• Provide guidance on disclosures to focus on structure, risks and impacts of branches and other related entities.
		Technical
		• Allowed by both IPSAS and IFRS and broadly consistent with the *IFRS for SMEs* Standard.
		• The specifications of benefits and relevant activities can be used to the determine control for NPOs.
		Practical
		• Principles provides flexibility to allow for variations in local environments.
		• Provides guidance on NPO-specific relationships and arrangements.
			Technical
			• Additional guidance may have the effect of turning a principles-based approach into a rules-based approach.
			Stakeholder
			• May impact comparability with other NPOs and entities in the public benefit and public sectors if there are different interpretations of the principles.
			Cost/benefit
			• The cost of determining whether control exists may outweigh the benefits, particularly for smaller entities.

Alternative 2 Prepare additional NPO-specific guidance on the nature of reporting entities and use pragmatic methods of assessment such as the power to govern financial and operating policies to define control.	• Prepare additional NPO-specific guidance about how to identify a reporting entity including branches. • Establish supporting guidance based on a pragmatic approach to identify control. For example, the power to govern the financial and operating policies of an entity to obtain benefits from its activities, ie where through direct or indirect ownership more than half of the voting power is held). • Guidelines would be based on 'bright lines' tests eg voting rights. Substantive judgments, ie control of financial and operating policies and/or materiality would be required based on the guidance. • Provide guidance on disclosures to focus on structure, risks and impacts of branches and other related entities.	**Technical** • Is currently consistent with the *IFRS for SMEs* Standard. **Practical** • May be easier to apply. • Provides guidance on NPO-specific relationships and arrangements. **Stakeholder** • May be easier for users to understand. • May improve comparability across NPOs. **Cost/benefit** • May be less resource intensive.	**Technical** • Is not consistent with the principles-based approach in IFRS or IPSAS. • A pragmatic approach risks being unable to properly reflect the economic circumstances of an NPO's interests. **Practical** Might be difficult to arrive at a single set of pragmatic methods that meet the needs of the broad range of NPOs in the sector.

Specific Matters for Comment 1

1.a Do you agree with the description of issue 1: Reporting entity and control (including branches)? If not, why not?

1.b Do you agree that the list of alternative treatments that should be considered for issue 1 is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.

1.c Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 1? If you do not agree, please set out the changes you propose, and why these should be made.

1.d Please identify the alternative treatment that you favour for issue 1, and the reasons for your view.

Issue 2: NPOs acting on behalf of other entities

1. Description of the issue

1.1 **Distinguishing between where an NPO acts as an agent for other entities or is acting in its own right is important.** This is to understand the accountability of an NPO, to provide transparency over its operating income and expenditure and to understand an NPO's operating model. However, it can be challenging to identify where an NPO is the principal, responsible for its own decisions.

1.2 **It may be difficult for an NPO to decide who is responsible for making the decisions** about the assets it has in its care. An NPO can act as an 'accountable body' for a grant even where an NPO distributes that grant to other NPOs or organisations. An NPO may be entitled to some of the grant itself, or may be responsible for the administration of the monies. The funder may deem an NPO distributing the funds to be accountable.

1.3 **NPOs might be responsible for distributing donor funds or grants**. NPOs can act as a custodian or a trustee of funds or assets for other entities. For example, an NPO may agree to pass on funds to other NPOs or agencies. This could be because it has particular expertise or knowledge in a local area where the principal entity does not. In these situations, an NPO will not have the ability to decide how such resources are allocated but may retain some accountability and have reporting requirements.

1.4 **It may be difficult to identify who is acting as principal if there are no formal agreements** setting out the arrangements between the parties. This is particularly where multiple tiers of entities, partnerships or consortia exist. For example, issues may arise in joint consortia, where an NPO may act as principal in one part of the consortium's activities, and agent in another because it is administering an activity.

1.5 **Use of sub-contractors to provide services or distribute funds might also make it difficult** to identify whether there is an agency relationship. An NPO might still be an agent if it only has the responsibility for distribution of the funds.

2. Financial reporting challenges

Recognition

2.1 **NPOs need to understand whether they have the rights to control cash or other asset they are holding,** be that its economic benefits or inherent service potential. If an NPO is acting as an agent, then the funds or assets

being held are not recognised by an NPO (and could be held in some form of holding account).

2.2 **Expenditure should not be netted off from any of the contributions received**, **when presented as income and expenditure, or within assets or liabilities,** where an NPO is acting as principal. Funds granted or donated should be presented gross.

Disclosure

2.3 **Disclosure may be required of the amounts passing through an NPO or assets in custody to provide transparency**. Donors and grant providers are likely to be interested in the security and fiduciary responsibilities that an NPO might have for funds passing through an NPO or the assets it is holding in custody. How these funds could be reported in the agent's financial statements are important. A gross reporting approach, similar to when an NPO is acting as principal could provide additional transparency.

2.4 **It is arguable that financial reporting should cover the full details of programmes that include both elements of agent and principal.** There is a need for clarity and transparency. There may be a need for users (eg donors and other funders) to fully understand the financial performance and the risks faced by NPOs where they are part of a consortium.

3. Current international guidance

3.1 Currently international guidance focusing on agency arrangements is included in the following standards:

- IFRS 10 *Consolidated Financial Statements*
- IFRS 15 *Revenue from Contracts with Customers*
- Section 23 of the *IFRS for SMEs* Standard[27]
- IPSAS 9 *Revenue from Exchange Transactions*[28]
- IPSAS 23 *Revenue from Non-exchange Transactions* (Taxes and Transfers)
- IPSAS 35 *Consolidated Financial Statements*.

3.2 Generally, the guidance provided by the standards is based on the core principle that an entity is principal if it 'controls' the economic resource in the transaction(s). Current international guidance has either a controls approach or risks and rewards approach to indicate control.

[27] The International Accounting Standards Board has initiated a programme to review the *IFRS for SMEs* Standard and in particular to consider updates for standards issued since the last update. This will include IFRS 15 *Revenue from Contracts with Customers.*

[28] The International Public Sector Accounting Standards Board will shortly consult on a new standard to replace IPSAS 9 *Revenue from Exchange Transactions* to reflect IFRS 15, as well as a linked update of IPSAS 23.

3.3 While the framework for assessing control differs, the guidance provides indicators to assist entities with the determination of whether an entity would be acting as principal, focusing on an entity's ability to control (or whether it is subject to risks and rewards of the good or service provided). These indicators include consideration of which entity has primary responsibility for the provision of the good or service to the customer, inventory risk, credit risk exposure and the ability to set prices for the good or service provided.

3.4 International standards both within their conceptual frameworks and in specific standards (for example, property, plant and equipment and the leasing standards), follow the principle that holding legal title to an asset is not sufficient to require its recognition in an entity's balance sheet. Again, what must be established is that an entity controls or has the right to control the economic benefits and service potential inherent in the asset.

Controls approach

3.5 IFRS 15, where revenue is provided in exchange for a good or service, is based on a control concept. IFRS 15 does not provide guidance on non-exchange transactions.

3.6 IFRS 10 requires entities to decide whether an investor is acting as principal or agent and/or whether it controls the entity it has an interest in. Guidance establishes that an investor engaged primarily to act on behalf of other parties does not control the investee and is an agent.

3.7 Similar to IFRS10, IPSAS 35 requires entities to decide whether an investor is acting as principal or agent and/or whether it controls the entity it has an interest in and provides guidance.

Risks and rewards approach[29]

3.8 The accounting treatment in the *IFRS for SMEs* Standard for agency relationships although not explicitly referring to 'risks and rewards' is included in Section 23 *Revenue* where decisions on the supply of goods are taken on the basis of a 'risk and rewards' approach. The *IFRS for SMEs* Standard specifies that in an agency relationship, the agent must recognise in revenue only the amount of its commission.

3.9 IPSAS 9 sets out that an entity is acting as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or the provision of services.

[29] Although there is a difference in the principles established for the determination of whether an entity is acting as agent or principal (ie the control or risk and reward framework), it is arguable that any outcomes are likely to be similar as risks and rewards are a subset of control though different decisions are possible.

3.10 Both IPSAS 9 and IPSAS 23 establish that amounts collected as an agent of the government (or another government organisation/other third party) will not give rise to an increase in net assets or revenue of the agent. This is because the agent cannot control the collected assets in the pursuit of its objectives. It establishes the same principle for fines. These principles are capable of being applied to other non-exchange transactions such as the distribution of grants.

3.11 Both IPSAS 9 and IPSAS 23 as well as the *IFRS for SMEs* Standard are in the process of being updated. The principles in IFRS 15 are specifically included within the considerations for both these work programmes.

4. National-level guidance[30]

4.1 Where a jurisdiction follows either IFRS Standards or IPSAS standards the principles established in section three largely apply.

4.2 One jurisdiction, following the general approach under international standards for accounting for transactions as principal or agent, provides specific guidance for charities, ie accounting for custodian funds as agents or trustee (custodian trustee). It establishes the principles for when a charity would treat such transactions as agent or principal. For example, as agent, the trustees of a charity are not able to take decisions about the use to which the funds received are put. It also provides for situations where a charity holds the title of a property on behalf of another charity.

4.3 This jurisdiction stipulates that for transactions where a charity is acting as agent (eg receipt of funds) they are not recognised in a charity's accounts, because they are not the income of the charity. Fees receivable are recognised. It also provides the accounting requirements for consortia indicating that the:

"*Lead charity is not acting as agent if it is the principal under the contract and is then subcontracting work to third parties.*"

There are also requirements to disclose an analysis of funds and assets held as agent and as custodian trustees.

4.4 The guidance provided in another jurisdiction is similar but includes detailed provisions on the treatment of transactions including the treatment of financial intermediaries. Whether a recipient NPO that is an intermediary is either principal or agent is dependent on whether an NPO has discretion in the distribution of the money to the beneficiaries. If discretion exists, or if an NPO is a financially related entity, an NPO is the principal in the transaction. If it has

[30] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

no discretion, it recognises an asset and a liability (for amounts which have not yet been distributed).

4.5 In this jurisdiction if the asset is a non-financial asset an NPO is able to choose an accounting policy to not recognise this transaction. This accounting policy choice would need to be disclosed and must be consistent between reporting periods. Under this national GAAP there is no requirement to present the gross amount received.

4.6 Another jurisdiction provides guidance on when amounts should be reported gross in the financial statements. It also states that revenue should only include gross inflows of economic benefits received on its own account. It uses the risks and rewards approach to determine when an NPO is principal or agent.

5. Alternative financial reporting treatments

5.1 Internationally, national standards require transactions to be recognised in the financial statements based on whether the entity controls the transaction, but there are differences in how control is assessed.

5.2 All alternatives propose to include additional NPO-specific examples and guidance that illustrate typical NPO arrangements. They also propose additional disclosure requirements that provide, for example, transparency of material transactions and balances for assets held on behalf of others. Additional disclosures will be advantageous to stakeholders.

5.3 Additional disclosure requirements could increase the reporting burden (and potentially audit fees), particularly for smaller NPOs. However, practical guidance for NPO account preparers will assist NPOs in making relevant judgements and reduce the inconsistent treatment of transactions through differing interpretations of the core standards.

5.4 **Alternative 1** is based on IFRS Standards and uses the indicators of control identified in Section 3 for IFRS 10.

5.5 **Alternative 2** is based on the *IFRS for SMEs* Standard which effectively adopts a risks and rewards approach. The *IFRS for SMEs* Standard is being reviewed to consider newly issued IFRS Standards, which includes IFRS 10. A risks and rewards approach is likely to give a similar outcome to that in alternative 1.

5.6 **Alternative 3** is based on IPSAS which currently supports a risks and rewards approach. The existing standard is in the process of being updated and current proposals are for a controls basis consistent with IFRS 10. Once updated, IPSAS is likely to deliver the same outcome as alternative 1.

5.7 Given the current work programmes of IPSASB and the IFRS Foundation, it is possible that full IFRS Standards, the *IFRS for SMEs* Standard and IPSAS will all follow the same approach to control within the lifetime of this project. In practice it is possible that all approaches may therefore harmonise on alternative 1.

	Description	Advantages	Disadvantages

Alternative 1
Follow IFRS Standards – based on control with additional guidance and non – profit examples and with additional disclosure requirements.
	• NPOs would determine whether they were acting as principal or agent based on whether they control the resources involved in a relevant transaction.
	• No transactions (other than cash flows) would be recognised in the financial statements where an NPO determines that it is acting as an agent in a relationship or for a set of transactions.
	• Additional guidance on how control is determined and how to measure the asset held with specific examples to illustrate NPO arrangements.
	• Additional disclosures of material agency relationships NPO, including:
	  • a description of the entities or individuals involved in the relationship
	  • a reconciliation from opening to closing balances of material agency transactions,
	  • any major variances.
		Technical
		• Other standards may be moving to IFRS Standards definitions, so this alternative may be more technically enduring.
			Practical
			• It might be difficult to provide examples that work and illustrate the relationships for all forms of NPOs.
			• It may be demanding, particularly for smaller NPOs to collate the information necessary to make the judgements about the indicators of control.
			Cost/benefit
			• May result in additional costs to make assessments which outweigh the benefit

Alternative 2
Follow the *IFRS for SMEs* Standard where decisions on agent and principal are made on an exposure to risks and rewards. Additional guidance and not for profit examples and with additional disclosure requirements.
	• NPOs would determine whether they were acting as principal or agent based on whether an NPO was exposed to significant risks or rewards in a transaction or relationship.
	• No disclosure of transactions (other than cash flows) where an NPO determines that it is acting as an agent in a relationship or for a set of transactions.
	• Additional guidance on how control is determined and how to measure the asset held with specific examples to illustrate NPO arrangements.
	• Require disclosure of material agency relationships for an NPO, including:
	  • a description of the entities or individuals involved in the relationship
	  • a reconciliation from opening to closing balances of material agency transactions,
	  • any major variances.
		Practical
		• May be easier to implement given the simplified basis of considering risks and rewards.
			Technical
			• Inconsistent with NPOs determining whether they are acting as agent or principal under a control framework.
			Practical
			• It might be difficult to provide examples that work and illustrate the relationships for all forms of NPOs.

	Description	Advantages	Disadvantages

Alternative 3
Follow IPSAS where decisions on agent and principal are made on an exposure to risks and rewards. Additional guidance and not for profit examples and with additional disclosure requirements.
	• NPOs would determine whether they were acting as principal or agent based on whether an NPO was exposed to significant risks or rewards in a transaction or relationship.
	• No disclosure of transactions (other than cash flows) where an NPO determines that it is acting as an agent in a relationship or for a set of transactions.
	• Additional guidance on how control is determined for agency and principal relationships with specific examples to illustrate NPO arrangements.
	• Require disclosure of material agency relationships for an NPO, including:
	  • a description of the entities or individuals involved in the relationship
	  • a reconciliation from opening to closing balances of material agency transactions,
	  • any major variances.
		Practical
		• May be pragmatically easier to implement.
			Technical
			• Inconsistent with NPOs determining whether they are acting as agent or principal under a control framework.
			• May soon be out of date with the proposals to move to a control framework.

Specific Matters for Comment 2

2.a Do you agree with the description of issue 2: NPOs acting on behalf of other entities? If not, why not?

2.b Do you agree that the list of alternative treatments that should be considered for issue 2 is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.

2.c Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 2? If you do not agree, please set out the changes you propose, and why these should be made.

2.d Please identify the alternative treatment that you favour for issue 2, and the reasons for your view.

2.e Additional disclosures are proposed under all alternatives for issue 2. Outline any challenges you would anticipate with the proposed disclosures? Are there additional disclosures that might be more relevant?

Section 2: Accounting for incoming resources

Section 2: Accounting for incoming resources

Issue 3 – Non-exchange revenue

The recognition and measurement of revenue (in particular non-exchange revenue)[31] has been identified as a specific issue for non-profit organisations.

Some of the specific questions that this topic is seeking to address are:

- What are the overarching principles for the recognition and measurement of incoming resources from 'non-exchange' transactions?
- Timing of income recognition and definition of performance criteria/ obligation. What is the recognition and measurement process when receiving donations that are used to fulfil requirements in subsequent periods?
- When should donations to purchase a capital asset be recognised? What if the donation is repayable if the asset, at some future date, is no longer used for its intended purpose?
- When should services in-kind be recognised and if so, how are they measured? What disclosures should be provided?
- When should gifts in-kind be recognised and how should they be measured, including low value items such as inventory (second-hand for sale and new for distribution as part of charitable activities)?
- How should assets that can only be used for a specific purpose and may have to be returned be measured initially and subsequently?
- Recognition and measurement of 'right of use' donations (including free use of space and equipment)?

No sector specific issues regarding exchange revenue (ie revenue from commercial type arrangements such as providing services to third parties for a fee) were identified. Consequently, this section only considers non-exchange revenue.

It is not proposed that the issues associated with accounting for bequests is specifically covered in the initial Guidance and will be considered in a later phase.

[31] Non-exchange revenue arises when an entity receives value from another entity without directly giving approximately equal value in exchange.

Issue 3: Non-exchange revenue

1. Description of the issue

1.1 **NPOs receive non-exchange revenue from a variety of different resources**. NPOs rely on grants, cash donations, donations of individual items (gifts in-kind), donations of services or volunteer time (services in-kind) and bequests and endowments in order to meet their objectives. In this issue paper grants received/receivable, whether or not they have accompanying conditions are considered to be non-exchange revenues.

1.2 **NPOs may also receive exchange revenue.** Exchange revenue is revenue earned from the sale of goods (eg merchandise) and services (eg health services, tuition fees and membership services), research and from the use of the entity's assets (eg interest, royalties and dividends). No sector-specific issues have been identified with exchange revenue. This issue paper considers the issues relating to non-exchange revenue only.

1.3 **Revenue may appear to comprise both an exchange and non-exchange component in some transactions.** For example, a donor may receive goods after making a donation, but the value of these goods is clearly lower than the amount donated. This may raise a question about whether part of the donation is a purchase of goods (exchange). Similarly, an NPO may provide services such as healthcare or education for a charge that is less than the cost of providing the services because they are subsidised by grants. An NPO may face difficulties and/or additional costs if it is required to attribute incoming resources between these types of transactions.

1.4 **Non-exchange revenue transactions raise specific issues.** These issues relate to the recognition, measurement and disclosure of non-exchange revenue.

Recognition (including timing where there are conditions and restrictions)

1.5 **It may not be clear when an NPO is entitled to the resource** (cash or other assets) as there may be conditions (performance requirements) that require an NPO to use the incoming resources as determined by the donor. NPOs may not be entitled to the resources until they have performed these activities (for example, grants may be repayable if the related activity is not carried out).

1.6 **A donor may impose restrictions on how the resources it has provided are used.** If the donor has imposed a restriction (either temporary or permanent), an NPO may be entitled to the funds but can only use the resources towards specific purposes.

1.7 **Conditions and restrictions can create complexity for NPOs.** There are different views about when the stipulations imposed by a donor are a condition and when they are a restriction. Differing views lead to inconsistency in whether an NPO recognises revenue (through the statement of financial performance), or a liability for future performance (through the statement of financial position). Knowing when to recognise revenue can be a particular issue for multi-year grants.

Measurement

1.8 **NPOs may find it difficult to estimate the value of some of the resources provided** and therefore how to record their value. This includes services in-kind and gifts in-kind (whether inventory items or other assets). Examples of the difficulties NPOs may experience include:

- Donated items may not have a readily available cost or market value, and may be specialised or have restrictions, making them difficult to value.
- It may be impractical to value low value/high volume inventories provided for resale.
- Donated items such as medical supplies may reach their expiry dates in the near future, making them difficult to value.
- Capturing the volume and value of in-kind services can be challenging, particularly when these are volunteers providing general services.

Disclosure

1.9 **Incorrect categorisation of incoming resources can lead to lack of transparency** about the funds/resources available for ongoing activities. Stakeholders might expect the accounts to show that the resources that they have provided have been used as they intended, and to disclose the restrictions imposed on donated resources.

1.10 **Stakeholders use information to make decisions** and lack of transparency may impact understanding. Stakeholders want to understand what has happened to the resources they have provided but producing financial information that is useful may be challenging for a number of reasons including timing differences. The features of non – exchange transactions may make this more difficult.

2. Financial reporting challenges

2.1 **Table 2.1 summarises the financial reporting challenges** and their significance (– high, – medium and – low) to each type of non-exchange revenue.

Table 2.1: Summary of paragraphs relevant to different types of non-exchange transaction

Issue	Cash Transfers	Gifts In-Kind	Services In-Kind
Recognition – control	2.2 – 2.4	2.2-2.5	2.2 – 2.5
Recognition – reliable measurement		2.6-2.8	2.9
Recognition – timing	2.0-2.14	2.10-2.12 and 2.15	2.10-2.12 and 2.16
Measurement		2.17 and 2.18	2.17 and 2.19
Disclosure	2.20-2.22	2.20-2.22	2.20-2.23

Recognition (control)

2.2 **Ascertaining control over resources provided might be challenging and at a disproportionate cost.** NPOs need to be certain that they have control over the resources provided for them to be recognised. For some types of resources (eg services in-kind) an NPO might need additional systems to ascertain the amount of resource it controls.

2.3 **When donors can change their mind an NPO is not likely to control the asset**. Some donations are made through pledges or bequests, which do not bind the donor. Defining the point at which control passes, which is most likely to be when the asset has been received, will affect the timing of revenue recognition.

2.4 **NPOs may need to determine what resource they control.** Where a donor provides an asset for an NPO to use and then return to the donor, an NPO will need to determine whether the donation is for the asset (a gift in kind) or a right to use the asset for a period (a service in kind).

2.5 **Only services in-kind or outputs of services provided in-kind that are under the control of an NPO can be recognised**. An NPO can recognise revenue in respect of the services in-kind that have arisen because of something that happened in the past (a past event) and an NPO expects to get a future benefit to further its objectives. This can apply even if that future benefit is used straight away. NPOs need to have records and processes to demonstrate control.

Recognition (reliable measurement)

2.6 **If an NPO cannot obtain a reliable measurement of the value of a donated item, an NPO will not be able to recognise any revenue** as a result of receiving the donated item. For an NPO to measure the value of a gift in-kind it needs to know the date that it took control of it and be able to determine a reliable estimate of its value at this date. The costs of obtaining a reliable value may be disproportionate to its value and outweigh the benefits that having a value will provide.

2.7 **It may be impractical for an NPO to determine a reliable estimate for low value/high volume items given for resale**. As a consequence, no revenue would be recognised as the point that the donated items are received. In such circumstances, revenue could be recognised at a later point, ie when the items are sold, rather than when they are received.

2.8 **It may be difficult to prepare a reliable estimate for items received for onward distribution even if the value of each item is known**, because some items may have a zero value if they cannot be used (ie because they have an expiry date) or sold. Practical difficulties can arise in determining what proportion of the items donated have a value, because it may not be possible to estimate the amount that can be used. The measurement of such items is discussed in issue paper 6 on the measurement of inventory held for use or distribution.

2.9 **Similarly, if services in-kind cannot be measured, they cannot be recognised.** It can be difficult to reliably measure a service in-kind such as assigning a value to volunteers' time. For an NPO to recognise services in-kind as either an asset or an expense, an NPO must be able to reliably measure the service in-kind. Volunteers who donate their time for general activities that do not require specific qualifications or skills may be particularly difficult to measure, because it may be difficult to capture the number of hours and estimate the value of the services provided.

Recognition (timing)

2.10 **Determining in which financial reporting period revenue should be recognised can be a challenge**. Revenue can only be recognised once any substantive performance requirements (conditions) have been satisfied. These are performance requirements that are most important and central to the arrangement. Revenue may need to be deferred if conditions have not been met.

2.11 **NPOs may need to recognise a liability where resources have conditions**. The liability would represent an NPO's obligation to undertake the activities necessary to meet the conditions, or to return the resources to the donor. Judgements may be needed about the chances of having to refund revenue and when the likelihood of giving a refund diminishes from likely, to possible to unlikely. These judgements need to be quantified to determine the value of any liabilities that arise from these arrangements.

2.12 **The substance of the conditions imposed need to be considered, not just their form**. Identifying the performance requirements or conditions and determining how they affect the recognition of an NPO's revenue can be a challenge. Guidance may be required on materiality and costs against benefits considered.

2.13 **Stipulations attached to cash given for the construction of assets raise specific financial reporting challenges.** The requirement to use a capital

asset as intended may be for a set period, or open-ended. These terms may be considered a performance requirement (condition) with revenue deferred until the risk of repayment has reduced, or alternatively considered a restriction on the use of the asset, with revenue recognised immediately. If treated as a restriction, a subsequent change in use would trigger a repayment as a separate event. There may also be a challenge in understanding when a condition is met, over the period that the asset is constructed or acquired, or over the lifetime of the asset.

2.14 **NPOs need to determine how much revenue to recognise when cash is received in arrears**. Some cash transfers are paid in arrears, with the cash transfer only falling due once conditions have been met (either in full or in part). NPOs with an expected entitlement may need to determine the amount of revenue to recognise and recognise a corresponding debtor for cash they are yet to receive.

2.15 **It is possible that revenue is never recognised for items received for onward distribution**. As well as not recognising revenue on receipt of a donated item (see paragraph 2.8), revenue might also not be recognised subsequently if there are no proceeds. Where the value of individual items is known, revenue (and a corresponding expense) could be recognised when the item of inventory is used. This would provide more useful information about the cost of an NPO's activities.

2.16 **An NPO that receives services in-kind and recognises revenue, will usually consume the benefits immediately**. This would lead to an expense and revenue being recognised when the services are received to reflect the use of the service provided. Services in-kind can also be provided for the construction of assets, in which case the cost of the asset being constructed should arguably include the value of the services in-kind.

Measurement

2.17 **Measuring services or assets that have been gifted can be problematic.** Assigning value is not generally an issue for cash transfers but can be challenging where donations take the form of gifts in-kind or services in-kind.

2.18 **Determining the value of donated capital assets, both tangible and intangible may be challenging and impact the amount of revenue**. For example, if housing donated to an NPO for social purposes could be sold for a higher price for use as commercial development it might be argued that the social housing is measured to reflect the value as commercial development land. This may not appropriately reflect the social nature of an NPO's objectives or the service potential that it might obtain from the asset.

2.19 **Services provided on a commercial basis may be more easily measured than other services** as market prices may exist. Where a service would have

been purchased if it had not been donated, it may be more easily measured, and this is a stronger argument for recognition.

Disclosure

2.20 **Allocating revenue that contains a mix of exchange and non-exchange revenue may be onerous**. Although this issue paper only considers non-exchange revenue, a requirement to identify the exchange and non-exchange components of a transaction might arise for recognition, measurement or disclosure purposes.

2.21 **Standardising the presentation of revenue in the financial statements can assist understanding** of the sources of funding for an NPO. Revenue that has been recognised immediately, but is subject to restrictions, needs to be identified. Categorisation of revenue, particularly if there are different accounting treatments for different types of revenue is also important. Stakeholders may benefit from increased standardisation to access the information they need to understand the extent that revenue can be generally used to fund to an entity's expenditure. Financial statement presentation is discussed in issue paper 7.

2.22 **Additional disclosures may be needed to provide transparency** and ensure that stakeholders have an accurate picture of an NPO's financial position. Disclosures about material amounts or activities, fundamental to the operations of an NPO, could be designed. This would enable users to have visibility of the nature, amount, timing and uncertainty of revenue as well as items that have not been recognised in the financial statements that could aid understanding for all stakeholders.

2.23 **Additional disclosures are likely to lead to additional cost**. The costs of preparing additional disclosures may be disproportionate to the benefits. Some entities may also not have the resources to provide the information.

3. Current international guidance

3.1 Currently international guidance on the recognition and measurement of revenue is included in the following standards:[32]

- IAS ® 20 *Accounting for Government Grants and Disclosure of Government Assistance*

[32] There are a number of other standards that address revenue related accounting. This includes the accounting standards for leases (lease revenues), revenue from construction contracts (IPSAS only), insurance contracts, and provisions, contingent liabilities, and contingent assets. These are not included in the discussion of this topic. Similarly, accounting standards dealing with the recognition and measurement of assets are not included in the discussion of this topic.

- Section 23 and section 24 of the *IFRS for SMEs* Standard[33]
- IPSAS 23 *Revenue from Non-exchange Transactions* (Taxes and Transfers).

3.2 All standards support the gross reporting of inflows of economic benefits received and receivable by the entity on its own account.[34]

3.3 All standards require the initial measurement of revenue to be based on fair value. Fair value may be ascertained by reference to an active market or by appraisal. Where an appraisal uses present value techniques, discounting may be required to reflect the time value of money. Exchange transactions are measured at the consideration received (after discounts) and non-exchange transactions are measured at the fair value at the date of acquisition.

3.4 Generally, the guidance provided by the standards is based on the core principle that revenue is recognised when it is probable that the entity will receive the economic benefits associated with the transaction and that it can be reliably estimated. This applies to revenue from exchange and non-exchange transactions. The guidance also requires that an entity has control over the asset (whether this is cash or other assets).

3.5 All standards require a minimum presentation of incoming resources. Further disclosures including the disaggregation of significant balances are required. For non-exchange transactions this goes to the nature and type of these transactions.

Non-exchange transactions

3.6 IAS 20 provides guidance on the accounting of revenue from government grants. Revenue from government grants is recognised on a systematic basis over the periods that the entity recognises as expenses the related costs that the grants are intended to compensate. IAS 20 allows grant revenue provided for capital assets to be recognised over the life of the asset, either by recognising deferred revenue in the statement of financial position, or by deducting the grant when determining the carrying amount of the asset.[35]

3.7 The *IFRS for SMEs* Standard also addresses the treatment of government grants. Unlike IAS 20, the *IFRS for SMEs* Standard requires that a grant that imposes specified future performance requirements is only recognised as revenue as or when the performance requirements are met without an option to deduct the grant when determining the carrying amount of the asset.

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[33] The International Accounting Standards Board has initiated a programme to review the *IFRS for SMEs* Standard and in particular to consider updates for standards issued since the last update. This includes IFRS 15 *Revenue from Contracts with Customers.*

[34] IAS 20 does however include an option to net a grant against the cost of an asset or the related expense.

[35] This standard allows the netting of expenses, which was permitted by the conceptual framework at the time. Netting of expenses is not permitted by the current IFRS conceptual framework.

3.8 The recognition criteria and measurement bases in the IFRS *Conceptual Framework* could be applied to other non-exchange revenue that are not government grants. Similarly, the recognition criteria and measurement bases in section 2 of the *IFRS for SMEs* Standard, *Concepts and Pervasive Principles* could be applied to other non-exchange revenue for those using the *IFRS for SMEs* Standard. Applying these concepts would in both cases result in revenue and an asset being recognised at fair value when an NPO controls a donated item. If a condition gives rise to a present obligation for an NPO, a liability (rather than revenue) may be recognised until the obligation has been satisfied (at which point the liability is derecognised and revenue recognised).

3.9 IPSAS 23 describes non-exchange transactions as those transaction where the 'entity receives value without directly giving approximately equal value in exchange'. This includes cash transfers. The standard defines separately conditions and restrictions which form stipulations. Under IPSAS 23, conditions include a 'use or return' requirement, ie the entity is required to return resources to the donor where the conditions are not met. Where conditions are attached to a cash transfer, a liability is recognised being the present obligation that arises because of the conditions. Restrictions are stipulations that do not have this use or return requirement. Where restrictions are attached to a cash transfer, no liability is recognised, and revenue is recognised immediately. The main difference between IPSAS 23 and the *IFRS for SMEs* Standard is that IPSAS 23 requires there to be a use or return requirement for a stipulation to be a condition; the *IFRS for SMEs* Standard does not.

3.10 The IPSASB has recently published ED 70, *Revenue with Performance Obligations*, and ED 71, *Revenue without Performance Obligations*. Under these proposals, revenue would be recognised when conditions are met. Where the cash has already been received, a liability is recognised until conditions have been met. Where the conditions are satisfied before the cash is received, an asset will be recognised. Unlike IPSAS 23, ED 71 does not require there to be a use or return requirement before revenue is deferred. In this respect, the proposals in ED 71 and the requirements in the *IFRS for SMEs* Standard are similar.

3.11 ED 71 explicitly addresses cash transfers to acquire or construct a capital asset. It proposes that revenue from such cash transfers would be recognised as the asset is either procured or constructed, and not over the useful life of the asset.

3.12 IPSAS 23 specifically addresses services in-kind. Entities are permitted, but not required, to recognise revenue from services in-kind. Entities are encouraged to disclose the nature and type of major classes of services in-kind received, including those that are not recognised.

Fair value

3.13 IFRS 13 sets out how to measure fair value but does not specify when fair value is to be used (this is addressed in other IFRS). Under IFRS 13, fair value is defined with reference to an exit price (that is, the price that could be achieved by selling the asset), assuming a highest and best use. Highest and best use takes into account any legal restrictions over an asset. Consequently, if a building was donated to an NPO with a restriction, the fair value would reflect that restriction.

3.14 In IPSAS, fair value[36] is defined in IPSAS 9 *Revenue from Exchange Transactions* as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." This definition, by referring to an exchange rather than a sale, includes both exit values (best price from a sale) and entry values (cost of replacing the service potential an NPO will gain from using the asset).

4. National-level guidance[37]

4.1 National standards have variously been converged on IFRS Standards, the *IFRS for SMEs* Standard or IPSAS, or set independently of international standards. The differences in revenue recognition between the international standards are therefore replicated to an extent in national standards. Jurisdictions may permit or require exceptions to the general recognition and measurement requirements for revenue, primarily in respect of gifts in-kind and services in-kind. They may also require specified disclosures. These vary across jurisdictions.

4.2 One jurisdiction provides guidance that is generally converged with the *IFRS for SMEs* Standard, with some additional options based on IFRS Standards. The guidance covers government grants, which can be accounted for using either the accrual model (based on IAS 20) or the performance model (based on the *IFRS for SMEs* Standard). Guidance is also provided on other non-exchange revenue; this guidance follows the performance model in the *IFRS for SMEs* Standard. This may result in government grants and cash transfers from other sources having different accounting treatments. To avoid this inconsistency, some sector specific guidance disallows the use of the accrual model. This jurisdiction also provides specific guidance for gifts in-kind and services in-kind:

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[36] Having two definitions of fair value could be confusing, which is one of the reasons the IPSASB, in its Consultation Paper *Measurement*, proposed adopting a definition of fair value that is consistent with IFRS 13. The IPSASB has also proposed using an alternative term for those circumstances in which a current value using entry prices (the cost of replacing an asset's service potential) will be necessary in the public sector.

[37] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

- Entities must consider whether gifts in-kind can be measured reliably and whether the benefits of recognising the gifts in-kind as assets outweigh the costs. Where it is impractical to estimate the value of a donated item with sufficient reliability, no asset (and therefore no revenue) is recognised on receipt; revenue is recognised in the financial period that the donated item is sold. In the absence of an open market, a valuation may be derived from other sources, for example the cost to the donor, or the estimated resale value (after deducting costs to sell). Where items are distributed at no cost, an expense and revenue are recognised at the same time.
- Services in-kind are recognised as revenue and an expense when they can be measured reliably. Services that an entity would otherwise have purchased are recognised at the value to the entity; other services are recognised at a fair value. Disclosures are required where services in-kind are not recognised.

4.3 One jurisdiction provides guidance that is generally converged with IFRS Standards. Additional guidance is provided on the application of IFRS 15 to NPOs, particularly where services are provided to third-party beneficiaries. Additional guidance is provided on non-exchange revenue, which is recognised immediately except where the transaction requires an NPO to acquire or construct a non-financial asset. In these circumstances, revenue is recognised as the entity satisfies the conditions attached to the transfer (ie as the asset is acquired or constructed).

- No specific guidance is provided on the recognition of gifts in-kind (as opposed to in cash), although NPOs are encouraged to disclose inventory held but not recognised.
- An NPO can recognise volunteer services at fair value if they can be measured reliably, regardless of whether the services would have been purchased if they had not been donated. An NPO is encouraged to disclose information about volunteer services it receives, including those it has not recognised in the financial statements.

4.4 One jurisdiction provides guidance for NPOs generally converged with IPSAS, with some additional guidance for NPOs included. Simplified guidance is provided for smaller organisations but follows the principles in IPSAS 23; that is, donations are recognised immediately unless there are conditions including a use or return requirement. This standard setter also provides specific guidance for gifts in-kind and services in-kind:

- Guidance for larger organisations allows an option not to recognise gifts in-kind that meet the definition of inventories if it is not practicable to reliably measure their current value. Gifts in-kind for resale give rise to revenue when they are sold. No revenue is recognised in respect of gifts in-kind for distribution to beneficiaries. This can result in inventory not being included

in an NPO's balance sheet. Guidance from the same standard setter for smaller entities does not require revenue to be recognised for the receipt of gifts in-kind (although revenue would be recognised if goods were subsequently sold). A gift in-kind of a significant fixed asset is recognised as an asset and revenue.
- Larger entities may recognise volunteering services that can be reliably measured at fair value. For smaller entities recognition of volunteering services is optional, with a requirement for information about significant services received to be disclosed.

4.5 Two jurisdictions have developed national standards not based on international standards and require non-exchange revenue to be recognised immediately where the donations do not include conditions. In one jurisdiction where the donation does include conditions, revenue recognition is deferred only where a use or return requirement is attached to the condition. This approach is similar to that in IPSAS 23. Net assets with donor restrictions (ie where there is no use or return requirement) must be presented separately from net assets without restrictions.

- This jurisdiction does not permit or require any variation from fair value measurement but provides additional guidance on assessing fair value for gifts in-kind and donated fixed assets. NPOs are not required to recognise contributions of art, historical treasures, and similar items (sometimes referred to as heritage assets) if they are added to collections.
- Services in-kind are recognised (at fair value) where they either create or enhance a non-financial asset; or require skilled labour that would need to have been purchased if not provided by donation.

4.6 In the other jurisdiction where the donation includes conditions, the standard setter provides an accounting policy choice for the recognition of donations. One policy option permits donations with contributions to be recognised using a deferral method, where the donations are recognised in the period related to the corresponding expenses. This approach is similar to that in IAS 20 (where the cash transfer is not related to an asset). The alternative approach permits revenue to be recognised immediately, but presented as part of a separate restricted fund, which will also show the related expenses. This national standard setter is currently reviewing its guidance on contributions. This standard setter also provides specific guidance for gifts in-kind and services in-kind:

- An entity may choose to recognise contributed capital materials and services when current value can be reasonably estimated, and the materials and services are used in the normal course of operations and would otherwise have been purchased. Revenue in respect of a donated capital asset may be deferred and recognised on the same basis as the depreciation of the capital asset. This is similar to the approach in IAS 20.

Alternatively, the restricted fund method may be used.

- Services in-kind may be recognised at fair value if they can be measured reliably and would otherwise have been purchased for use in the normal course of operations or to construct an asset.

5. Alternative financial reporting treatments

5.1 The *IFRS for SMEs* Standard forms the starting point for the first alternative. IFRS Standards forms the starting point for the second alternative with the remaining two alternatives based on IPSAS.

5.2 NPO-specific guidance will be provided under all the alternatives, including guidance to assist in distinguishing between exchange transactions and non-exchange transactions.

5.3 The accounting basis proposed in each of the alternatives are summarised in Table 5.1.

Table 5.1: Summary of the main differences between alternatives

	Framework for non-exchange revenue	**Exceptions to the framework**
Alternative 1	The *IFRS for SMEs* Standard	No
Alternative 2	IFRS Standards	No
Alternative 3	IPSAS	No
Alternative 4	IPSAS	Yes

5.4 **Alternative 1** requires all non-exchange revenue to be recognised in accordance with the *IFRS for SMEs* Standard. This would mean for non-exchange revenue other than government grants, that the *Concepts and Pervasive Principles* in the *IFRS for SMEs* Standard would be used to apply to other non-exchange transactions (ie NPOs would be required to recognise revenue from services in-kind and gifts in-kind where they can be reliably measured). Alternatively, the government grants requirements could be applied to other non-exchange revenue, as this is likely to result in similar accounting. Additional NPO-specific guidance would be provided.

5.5 **Alternative 2** requires non-exchange revenue to be recognised using the principles in IAS 20 to extend the treatment of government grants to other non-exchange revenue (ie to recognise revenue on a systematic basis over the periods that the entity recognises as expenses the related costs). Additional NPO-specific guidance would be provided to enable the consistent treatment of all non-exchange revenue. As with alternative 1 in applying these principles

NPOs would be required to recognise revenue from services in-kind and gifts in-kind where they can be reliably measured.

5.6 **Alternative 3** requires non-exchange revenue to be accounted for using the principles in IPSAS 23 (ie revenue is usually recognised when an NPO controls the assets but is deferred where there are conditions). Additional NPO-specific guidance would be provided. Consequently, the recognition of revenue from services in-kind would be encouraged but not mandatory, but all gifts in-kind would be required to be recognised where they can be reliably measured.

5.7 **Alternative 4** requires non-exchange to be accounted for using the principles in IPSAS. In addition, exceptions drawn from various national standards would be considered for inclusion as part of NPO-specific guidance. The exceptions could:

- Permit NPOs to recognise revenue from gifts in-kind donated for resale at point of sale rather than on receipt, where measuring their value is impractical.
- Permit NPOs to not recognise inventory or revenue on receipt of gifts in-kind donated for distribution, where measuring their value is impractical.
- Permit NPOs to recognise revenue and an expense when items are distributed or used to provide services.
- Require additional disclosures where an NPO uses one of the permitted exceptions.

5.8 A specific matter for comment seeks views on whether the exceptions proposed in alternative 4 should be available in the other alternatives.

	Description	Advantages	Disadvantages
Alternative 1 Use recognition and measurement principles from the *IFRS for SMEs* Standard with additional NPO-specific guidance.	• Government grants are recognised as revenue as or when conditions (performance requirements) are satisfied. • Other non-exchange revenue is recognised in accordance with the recognition criteria and measurement bases in the section 2, *Concepts and Pervasive Principles* (ie NPOs would be required to recognise revenue when an NPO controls the resources; this would also require the recognition of revenue from services in-kind and gifts in-kind where they can be reliably measured). Alternatively, the government grants requirements could be applied to other non-exchange revenue, as this is likely to result in similar accounting. • No specific requirements for gifts in-kind or services in-kind (follow the same principles as other non-exchange revenue).	**Technical** • Treatment of non-exchange transactions is consistent with IFRS Standards and follows without exception the *IFRS for SMEs* Standard. • Treatment is broadly consistent with IPSAS. **Practical** • Specific guidance may assist NPOs in their potentially complex arrangements. **Stakeholder** • Provides a framework for recognising revenue and guidance that might aid consistency.	**Practical** • NPOs may not have systems in place to recognise all services in-kind and gifts in-kind, particularly high volume, low value donations for resale and those services that would not otherwise been purchased. **Stakeholder** • The treatment of government grants is inconsistent with grants from other providers, impairing comparability within an NPO's financial statements. **Cost/benefit** • The cost of recognising and measuring all gifts in-kind and services in-kind on receipt may outweigh the benefits, particularly for smaller NPOs.

	Description	Advantages	Disadvantages
Alternative 2 Recognise all non-exchange revenue using the principles in IAS 20. NPO-specific guidance is provided.	• All non-exchange revenue is recognised on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate. • All gifts in-kind and services in-kind are recognised on receipt (subject to any conditions being satisfied and it being possible to measure them reliably).	**Technical** • Follows the *IFRS for SMEs* Standard. • The treatment of non-exchange revenue is consistent with treatment of government grants in IAS 20. **Practical** • Specific guidance may assist NPOs in their potentially complex arrangements. • The options available in IAS 20 may offer options that are easier to implement (eg netting capital grants received against cost of the asset). **Stakeholder** • Provides a framework for recognising revenue and guidance that might aid consistency.	**Technical** • Not consistent with the *IFRS for SMEs* Standard or IPSAS for non-exchange revenue. **Practical** • NPOs will need to be able to estimate the period in which related expenses will be recognised. • NPOs may not have systems in place to recognise all services in-kind and gifts in-kind, particularly high volume, low value donations for resale and those services that would not otherwise been purchased. **Stakeholder** • Comparability and transparency may be reduced if different entities take different approaches to non-exchange guidelines. **Cost/benefit** • The cost of recognising and measuring all gifts in-kind and services in-kind on receipt may outweigh the benefits, particularly for some NPOs.

	Description	Advantages	Disadvantages
Alternative 3 Recognise non-exchange revenue using the principles in IPSAS 23. NPO-specific guidance is provided.	Non-exchange revenue is recognised as conditions (performance requirements) are satisfied. Conditions always include a 'use or return' requirement. All gifts in-kind are recognised on receipt (subject to any conditions being satisfied and it being possible to measure them reliably). NPOs are encouraged but not required to recognise services in-kind.	**Technical** • Consistent with IPSAS and draws on guidance specifically written for non-exchange transactions. • Broadly consistent with the *IFRS for SMEs* Standard. **Practical** • Pragmatic approach, particularly for those smaller NPOs that may have difficulty measuring revenue from services in-kind at the point of receipt. **Stakeholder** • Increased consistency of revenue recognised for revenue with conditions. • Greater disclosure of non-exchange transactions.	**Technical** • Not consistent with IFRS Standards. **Stakeholder** • Allowing a choice of accounting policy for services in-kind may mean that NPOs' financial statements are not comparable with other NPOs. **Cost/benefit** • The cost of recognising and measuring all gifts in-kind on receipt may outweigh the benefits, particularly for smaller NPOs.
Alternative 4 Recognise non-exchange revenue using the principles in IPSAS 23. Introduce exceptions to the requirements for gifts in-kind based on some national standards. NPO-specific guidance is provided.	• All non-exchange revenue is recognised as conditions (performance requirements) are satisfied. Conditions always include a 'use or return' requirement. • Permit NPOs to recognise revenue from gifts in-kind donated for resale at point of sale rather than on receipt, where measuring their value is impractical. • Permit NPOs to not recognise inventory or revenue on receipt of gifts in-kind donated for distribution, where measuring their value is impractical. Permit NPOs to recognise revenue and an expense when items are distributed or used to provide services. • Permit (but do not require) NPOs to recognise services in-kind as revenue and an expense. • Require additional disclosures where an NPO uses one of the permitted exceptions.	**Technical** • Core recognition principles consistent with treatment of government grants in the *IFRS for SMEs* Standard. • Draws on guidance specifically written for non-exchange transactions **Practical** • Pragmatic approach, particularly for those smaller NPOs that may have difficulty measuring revenue from gifts in-kind and services in-kind at the point of receipt. **Stakeholder** • Increased consistency of revenue recognised where there are conditions. • Additional disclosures may overcome differences in recognition of gifts in-kind and services in-kind in the financial statements. • Provides a framework for recognising revenue and guidance that might aid consistency. **Cost/benefit** • Exceptions may reduce or avoid additional costs.	**Technical** • Not consistent with IFRS Standards. • Drawing on different frameworks might create gaps or lead to conceptual inconsistencies. **Stakeholder** • The use of exceptions may lead to lack of transparency.

Specific Matters for Comment 3

3.a Do you agree with the description of issue 3: Non-exchange revenue? If not, why not?

3.b Do you agree that the list of alternative treatments that should be considered for issue 3 is exhaustive? If not, please describe your additional proposed practical alternatives, and explain why they should be considered.

3.c Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 3? If you do not agree, please set out the changes you propose, and why these should be made.

3.d Please identify the alternative treatment that you favour for issue 3, and the reasons for your view.

3.e If you favour an alternative other than alternative 4 for issue 3, do you consider that the exceptions to the recognition and measurement of gifts in-kind and services in-kind should be available under your preferred option?

3.f Are there any practical considerations, for example impacts on tax or audit thresholds, or questions that arise in implementing your preferred option for issue 3?

Section 3: Accounting for outgoing resources (expenses and liabilities)

Section 3: Accounting for outgoing resources (expenses and liabilities)

In earlier research relatively few issues were identified that relate to the accounting for outgoing resources. In addition to grant expenses, described below, three other topics have been identified as having financial reporting challenges that are relevant to the accounting for outgoing resources.

One of the topics concerns the treatment of expenses when an NPO is acting on behalf of another organisation as an agent. This topic has both income and expense implications and as it relates to the relationship between entities it is presented alongside the topic on the reporting entity (issue 2).

Two of the topics; classification of expenses (issue 8) and fundraising costs (issue 9) are primarily concerned with the presentation and disclosure of financial information rather than how to account for these costs. These have been included with the other topics that relate to the presentation, scope and content of financial information.

Issue 4 – Grant expenses

Many NPOs make grants to other organisations to further their (the donor NPO's) objectives. This topic is primarily concerned with what expense should be recognised and when and to related disclosures.

Issue 4: Grant expenses

1. Description of the issue

1.1 **NPOs can award grants to other entities (including other NPOs) or individuals**. Grants can be purely cash or comprise cash and other assets. Grants may take the form of a 'promise to pay', potentially over multiple reporting periods, as well as the immediate transfer of cash to the recipient.

1.2 **Grants arrangements can be complex, involving multiple agencies**. For example, NPOs may award grants to NPOs (grant recipients) who in turn pass the funds and other assets on to other NPOs with only the final grant recipient providing specific services to service users. The final grant recipient will be the body carrying out the activity or function. These types of arrangements may create separate obligations for each grant awarding body. There will be different recognition points for grant expenses depending on the specifics of the transactions.

Recognition

1.3 **A grantor may be unsure when to recognise all or part of the grant expense because of multiple obligations on the recipient**. The obligations could require an NPO to perform either specific activities or generic activities as a condition to be entitled to receive the grant. For example, a grant may be given to provide health services for a period (generic activities) or to carry out a number of inoculations of school children (specific). In some cases, it may not be clear whether the terms of a grant impose an obligation on the grant recipient, for example, when the terms require the grant recipient to use the grant to meet the grant recipient's objectives.

1.4 **Understanding where a grantor's obligations end in practice creates a further challenge**. For example, if an entity does not comply with the grant conditions, questions are likely to arise as to whether an obligation to pay the grant continues to exist, or whether some or all of the grant has to be refunded.

1.5 **There can be a significant period of time before the grantor is able to confirm the activities have been performed**. Grant awarding bodies will not certify completion of a specific grant or project until the end of a grant awarding period. A grantor may not be certain that the recipients of the grant have met all of the conditions until this is complete. This can lead to uncertainty about recognition for financial statements preparers.

Disclosure

1.6 **Donors and other stakeholders will wish to have a clear understanding of an NPO's expenses, obligations and commitments**. Lack of guidance on grants may lead to inconsistency, which users of NPO financial statements may find causes difficulties in assessing financial performance. Guidance would provide clarity particularly where these grants are awarded through complex organisational arrangements, or over time. Guidance may also be beneficial for accounts preparers.

2. Financial reporting challenges

2.1 **Grant expenses are not currently explicitly covered in international accounting standards,** being non-exchange transactions**.** With no specific guidance on grant expense transactions to assist NPOs with recognition and measurement, the accounting treatment of grant expenses can be a significant issue for NPOs.

Recognition

2.2 **Difficulties arise because it is not always clear what has been promised to a grant recipient and what commitments have been created**. As grants can be awarded over multiple financial reporting periods an NPO will need to consider whether the whole amount should be recognised as an expense immediately or not recognised until the reporting period for which the grant is intended. Measurement issues may also arise when the time value of money is significant.

2.3 **Significant judgement may be required to determine when a grant expense should be recognised.** Grantors may impose conditions on the grant recipient which impact when a grant is recognised. Where these are documented in a grant agreement, recognition decisions may be clearer, but where no grant agreement exists this may be more challenging. Some conditions may be more significant than others, which can also impact on the consideration of whether or not the conditions have been met.

2.4 **When the grant is paid before conditions are met, particular issues can occur.** There might be two different circumstances:

- Conditions relate to how the grant is spent – in these cases the grantor may need to assess whether the conditions are met (which might take place in stages) or are likely to be met.
- Conditions relate to how items acquired by the grantee for the purposes of the grant programme continue to be used or if items are sold.

2.5 **A separate transaction may need to be recognised where there is an obligation to return an asset.** It is not normally the case that an awarding

body includes return conditions or stipulations. There may be legal barriers to the return of grants or contributions. However, when a grant agreement includes return conditions, the awarding entity may need to consider if it has an asset prior to the grant recipient satisfying its obligations under the grant agreement.

2.6 **Identifying an obligating event between parties in order to recognise a grant expense may be challenging**. This need exists whether the relationship from grantor to recipient is direct (ie from grantor to recipient) or indirect (ie from grantor NPO, to an intermediate NPO to the recipient). Indirect relationships make the transactions more complex. Additionally, any intermediate NPO will need to consider whether it is acting as agent in the transaction or whether it is acting as principal in awarding the grant to the recipient.

2.7 **Depending on the timing of the transfer/cash payment, an NPO may need to recognise an accrual or a provision in its accounts**. Where the grant recipient has met the grant conditions or when the grant has no conditions, an NPO will need to accrue these amounts. NPOs will need to consider each promise made to grant recipients separately. A portfolio approach to such grants may be possible in some instances.

2.8 **It is likely that there will be a contingent liability when an NPO has made a promise but cannot measure its value**. An NPO may have committed to make a grant payment (and has created an obligation) but the payment cannot be measured (perhaps because these are staged payments and the latest stage is not measurable). If it can be measured, then it would be a provision as set out in paragraph 2.7 above. Contingent liabilities would be disclosed in the financial statements.

Disclosure

2.9 **Disclosure about grants paid and commitments is important to stakeholders to provide transparency.** Disclosures about commitments not yet reflected in the accounts is important, particularly for NPOs that make significant grants**.** Consideration also needs to be given to the presentation of grants in the Statement of Financial Performance. An NPO will need to consider whether an analysis of expenses by nature or by function provides the best information to stakeholders.

3. Current international guidance

3.1 Currently international guidance does not explicitly deal with grant expenses. Current guidance rests under the general provisions for the recognition of provisions and the reporting of contingent liabilities within IFRS, the *IFRS for SMEs* Standard and IPSAS:

- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- Section 21 Provisions and Contingencies – the *IFRS for SMEs* Standard
- IPSAS 19 *Provisions, Contingent Liabilities and Assets*.

3.2 Under these standards an expense for a grant and a liability would be recognised when an NPO has a present obligation to fund another entity created by a past event, ie a commitment (or a constructive obligation), and the amount of the grant can be reliably measured. Recognition of the grant would take place when an NPO has no realistic alternative other than to settle an obligation to pay the grant (and it is therefore probable that there will be an outflow of resources).

3.3 When an expense is recognised it follows the relevant standards' requirements for presentation, measurement and disclosure of the expense and cross reference needs to be made to nature/function of expenses.

3.4 The timing of the recognition of a grant would be dependent on any conditions included in the grant (ie when the conditions are such that there would be no realistic alternative to settling the obligation to pay the grant). If there are no conditions and an obligation has been created, then the grant would need to be recognised as an expense in the reporting period when the obligation was created. When the time value of money is significant the grant would need to be recognised at present value.

3.5 As the current guidance does not explicitly address grant expenses, the existing standards do not provide specific guidance to cover performance obligations imposed by a grantor, nor does the guidance address the obligation made by the grantor, when agreeing to a grant.

3.6 IPSASB has a current project on Transfer Expenses which explicitly provides guidance for grant expense transactions. ED 72 *Transfer Expenses* defines a transfer expense an expense arising from a transaction, other than taxes, in which an entity provides a good, service, or other asset to another entity (which may be an individual) without directly receiving any good, service, or other asset in return.

3.7 ED 72 addresses recognition and measurement of performance obligations, distinguishing between where the transfer recipient is required to satisfy performance obligations by transferring goods or services to a third-party beneficiary and where the transfer recipient is not required to satisfy performance obligations. ED 72 also provides guidance which would address the accounting for multi-year grants.

4. National-level guidance[38]

4.1 A number of the jurisdictions follow international standards ie either IFRS Standards or IPSAS provisions following the accounting treatments for the recognition of the grants as outlined above in Section 3 of this issue paper.

4.2 Other jurisdictions are based on the same or similar provisions and provide additional guidance. One set of national guidance takes the general approach to the recognition of liabilities/provisions for grantors, but also explicitly includes the concept of performance obligations.

4.3 This national GAAP requires a liability and an expense to be recognised when a commitment has been made as long as the definition and recognition criteria for a liability have been satisfied, the obligation is such that the entity cannot realistically withdraw from it, and the entitlement of the other party does not depend on performance-related conditions.

4.4 Another jurisdiction has issued guidance on how to account for contributions made and received. It defines a promise to give as a written or oral agreement to contribute cash or assets to another entity. A promise to give may be either conditional or unconditional. Contributions made are recognised as expenses in the period made (immediately if unconditional, or once any conditions are met) and as decreases of assets or increases of liabilities depending on the form of the benefits given.

5. Alternative financial reporting treatments

5.1 Largely, international standards and national standards require an entity to recognise a liability and an expense when a grantor is committed to provide resources to the grant recipient (individual, organisation or entity). Some jurisdictions include provisions that explicitly refer to performance obligations or where the grant is conditional or has conditions that need to be met.

5.2 **Alternative 1** is based on either IFRS Standards, the *IFRS for SMEs* Standard or IPSAS with additional guidance to assist NPOs with NPO-specific issues. This would include recommended additional disclosures. The guidance could be prepared to align with one of these international frameworks, but in line with Part 1: Chapter 5, the preference would be the *IFRS for SMEs* Standard.

5.3 **Alternative 2** builds on alternative 1 but requires that the principles being proposed in IPSAS ED 72 *Transfer Expenses* are incorporated. Incorporating these principles would provide additional guidance on grants with performance obligations and multi-year arrangements.

[38] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

	Description	Advantages	Disadvantages
Alternative 1 Follow international standards (either IFRS Standards, the *IFRS for SMEs* Standard or IPSAS) and include additional guidance on recognition, measurement and disclosure including performance related conditions.	• Recognise a liability and an expense for the grant when an obligation has been created. • Provide additional guidance on performance related conditions. • Provide additional guidance on multi-year grants. • Provide guidance on the disclosure of grants and related commitments.	**Technical** • No departures from international standards. **Practical** • Additional guidance will provide relevant information to allow NPOs to decide when they have an obligation to pay a grant. • Additional guidance may assist NPOs decide how to recognise multi-year schemes.	**Stakeholder** • Lack of comparability across NPOs due to different interpretations.
Alternative 2 Follow either IFRS Standards, the *IFRS for SMEs* Standard or IPSAS, include additional guidance on recognition, measurement incorporating the performance obligation approaches proposed in ED72 by IPSASB, when IPSAS is not used as the base.	• Recognise a liability and an expense for the grant when an obligation has been created. • Provide additional guidance on performance related conditions. • Provide additional guidance on multi-year grants. • Provide guidance on the disclosure of grants and related commitments. • Specify that the grant awarding NPO will disclose significant transactions such that all users will understand the transactions and the commitments made by the grant awarding NPO.	**Technical** • Guidance from IPSAS may assist recognition decisions. **Practical** • Additional guidance may assist NPOs decide how to recognise multi-year schemes. **Stakeholder** • Increased comparability of grant reporting across NPOs.	**Technical** • May create departures from IFRS Standards or the *IFRS for SMEs* Standard for complex arrangements with multiple performance obligations.

Specific Matters for Comment 1

4.a Do you agree with the description of issue 4: Grant expenses? If not, why not?

4.b Do you agree that the list of alternative treatments that should be considered for issue 4 is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.

4.c Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 4? If you do not agree, please set out the changes you propose, and why these should be made.

4.d Please identify the alternative treatment that you favour for issue 4, and the reasons for your view.

Section 4: Accounting for financial and non-financial assets

Section 4: Accounting for financial and non-financial assets

A number of issues have been identified in earlier research that relate to non-financial assets. The topics include specialised assets held by NPOs, heritage assets, concessionary leases and service concession arrangements. There are also issues relating to financial assets, particularly concessionary loans.

Two of the topics (see below) are proposed for inclusion in the initial Guidance as they meet all four criteria for prioritisation. The remainder will be addressed as a later date.

Issue 5 – Measurement of non-financial assets held for social benefit

Tangible and intangible assets that are held for use in delivering the NPO's objectives and not for a financial return is a specific issue for NPOs, particularly where there is a need to impair them.

This topic is seeking to address matters related to:

- how assets are measured initially and subsequently
- impairment, including when an impairment is recognised, how it is measured and what disclosures should be made.

Issue 6 – Inventory held for use or distribution

Inventory held for use or distribution to service users has also been identified as a specific issue for NPOs, particularly where the inventory has been donated rather than purchased.

Some of the specific questions that this topic is seeking to address are:

- the initial and subsequent measurement of low value donated goods
- the measurement of perishable inventories and what disclosures should be made about these
- impairment, including when an impairment is recognised, how it is measured and what disclosures should be made.

Issue 5: Measurement of non-financial assets held for social benefit

1. Description of the issue

1.1 **NPOs use a wide range of assets in delivering services**. These can include such diverse assets as community facilities, warehouses or hospital buildings and equipment. The measurement of tangible assets (property, plant and equipment) in the non-profit sector may be more difficult than in the commercial sector because NPOs are far more likely to hold these assets for their service potential ie for social and public benefit purposes rather than for their economic or financial return.

1.2 **Assets might generate some cash inflows, even where they are primarily held for social and public benefit purposes**. For example, an NPO may run a community centre which offers classes for which it receives fees or provide classes free for all of the community. Although the community centre in this example is generating cash flows, an NPO's charitable objectives are such that it is doing so for social purposes.

1.3 **Issues might arise in determining the boundary between assets held for operational purposes and assets held for investment purposes.** For example, where an NPO has assets which are rented out, such as housing this could be for social benefit or to generate financial returns. This determination will depend on the objectives that an NPO has for the use of the asset.

1.4 **It may be important for stakeholders to understand the assets that are used to provide the services**, particularly their operating capacity. Donors and other funders may be particularly interested in understanding the position for assets to which they have contributed, and therefore how effectively their donations (and other funds) have been used.

Initial measurement

1.5 **NPOs may find it more difficult to record assets that have been donated**. NPOs may be readily able to measure an asset on acquisition if purchased or constructed itself. This is because it should have a full understanding of the original cost and any subsequent costs used to maintain or enhance the asset. However, both recognition and measurement can be more challenging were the asset has been donated.

1.6 **Sometimes it can be difficult to determine whether an NPO has rights to the benefits in the assets**. This may in turn lead to complexities in measurement particularly where the asset is given to an NPO for a time limited period or for

a particular task/project. This paper, however, does not consider these types of arrangements (right-of-use assets) where they are effectively a lease.

Impairment

1.7 **The value to an NPO from services that are supported by the assets may reduce if the assets become damaged or deteriorate (impairment)**. Depreciation schedules may need to be revisited or this may provide an indication that the asset should be subject to an impairment review. Also, the donor of an asset that has effectively been loaned, may require it to be returned earlier than originally expected, which will impact the value of the services that can be provided.

1.8 **It may be difficult to measure impairments where an NPO are using assets for their service potential rather than to maximise economic returns**. Where assets are impaired NPOs must ensure that the carrying amount does not exceed what it can get for that asset. In many cases the cash flows received for a building such as the example of the community centre in paragraph 1.2, where cashflows are used to estimate the value of the asset to an NPO, would not reflect the value of that use to an NPO.

2. Financial reporting challenges

Initial measurement

2.1 **Assets purchased or constructed are expected to be recognised at historical cost on initial recognition**. When an NPO acquires property, plant and equipment it needs to be included as an asset (initial recognition) on the statement of financial position (balance sheet), whether or not it generates revenue.

2.2 **All assets will remain recognised as on their balance sheets even where they are not cash-generating**, assuming that the assets are being fully utilised by an NPO to fulfil the objectives of an NPO (ie they have service potential). Service potential includes the use made by an NPO of an asset to deliver its objectives for the organisation's purposes.

2.3 **An estimate of the value of donated assets needs to be derived**. There can be challenges to determine an initial value as there have been no cost to an NPO. Establishing an appropriate value may be particularly challenging where an asset is donated that provides either more capacity or a higher specification than is needed by an NPO. The discussion of non-exchange revenue (issue paper 3) also considers donated assets.

Subsequent measurement

2.4 **Entities need to decide how to continue measuring the asset** once an asset has been recognised. International accounting standards require that asset values are updated at regular intervals (subsequent measurement). This can be either at historical cost (the 'cost model') or at a revalued amount. This is an important decision that needs to reflect the needs of an NPO's stakeholders.

2.5 **Historical cost as a basis of subsequent measurement spreads the initial cost of an asset over its useful life to the entity**. Accumulated balances show the 'cost yet to be consumed'. Historical cost may be attractive for use in subsequent measurement due to its ease of use and understandability for users. It provides a direct link to the transactions undertaken by an NPO.

2.6 **Measuring some assets using historical cost may not reflect their usefulness to an NPO**. Assets being held by NPOs are to provide services to service users and not principally for the income or economic returns they generate or their market value (the price for which an asset can be sold). A valuation that reflects the value of the assets to the business, for example, the cost of replacing the output of an asset may be more appropriate. If the value of an asset increases because of greater potential service provision, this would not be recognised in historical cost measurements.

2.7 **Measuring assets using the revaluation model may be costly**. NPOs would need to maintain asset valuations so that they are materially accurate at the reporting date. This may require substantial resource input from NPO staff and the input of valuation experts which may be cost prohibitive, particularly for smaller NPOs. In addition, NPOs will need staff who are sufficiently skilled to be able to draft instructions for the valuers.

2.8 **Assets that might be measured a 'highest and best use' could far exceed the operational value to an NPO** leading to difficulties in the application of the revaluation model. For instance, offices might be able to be converted into high value residential accommodation, but this use would not be within the purposes of an NPO. Measurement using the revaluation model may also raise questions of how depreciation should be charged and how impairment can be identified and measured, particularly where the overall value of an asset is increasing.

2.9 **Similar measurement issues may arise for intangible assets,** although these are less likely to be material or occur as frequently.

Impairment

2.10 **An annual impairment review is needed where there are indicators of impairment irrespective of whether the cost or revaluation model is**

used to assess whether the asset has a value lower than its carrying amount. An NPO may have difficulty in measuring the impairment as it may not have cash flow information from which impairments may be estimated. Where an NPO uses the revaluation model and is able to measure its value in use under that model, impairments are likely to be reflected through a deterioration in the service potential. This may require significant judgements by NPO management and is likely to require experts to provide these measurements.

Disclosure

2.11 **It may be important to donors and other stakeholders to understand the operational capacity of assets** when assessing the performance of particular services or activities to which they may have contributed. Where a valuation shows the operational capacity of an asset it could allow users to understand the real cost of consuming the resources provided by the assets to deliver services rather than what an NPO might have paid for them. However, where NPOs use the revaluation model, it needs to be clear how the information provided in the valuations contribute to stewardship and accountability.

2.12 **NPOs will need to explain the measurement bases it is using when disposing of assets to help users of the financial reports** where this is material. Where an asset becomes surplus to requirements the sale/disposal price may be materially different to the carrying value of the asset. Stakeholders will want to understand the difference between the economic value achieved on disposal and the value an NPO has derived from its use.

3. Current international guidance

3.1 International standards for the measurement of tangible assets and leases are:

- The *IFRS for SMEs* Standard sections 17 and 27
- IAS 16 *Property, Plant and Equipment*
- IPSAS 17 *Property, Plant and Equipment*
- IFRS 13 *Fair Value Measurement*
- IAS 36 *Impairment of Assets*
- IPSAS 21 *Impairment of Non-Cash Generating Assets*
- IPSAS 26 *Impairment of Cash Generating Assets*

Property, plant and equipment

3.2 The property, plant and equipment standards, including the *IFRS for SMEs* Standard, require that assets are initially measured at cost.

3.3 IAS 16, IPSAS 17 and the *IFRS for SMEs* Standard offer entities the choice of subsequently measuring property, plant and equipment using either the cost model or at the revalued amount and stipulate that this policy must be applied to the entire class of assets.

3.4 The standards also require that revaluations are made with sufficient regularity to ensure that the carrying amount would not be materially different from that which would be determined using fair value at the end of the reporting period.

3.5 The revaluation model under international standards requires entities to measure property plant and equipment at fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

Fair value

3.6 IFRS Standards determine that assets (or liabilities) measured at fair value must follow the measurement and disclosure requirements under IFRS 13 *Fair Value Measurement*. Fair value is defined in IFRS 13 as:

"The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

For non-financial assets, IFRS 13 requires that assets are measured at 'highest and best use'. IFRS 13 provides guidance on the techniques that are permitted by the standard ie the market approach, the cost approach (which would allow in certain circumstances for measurement at depreciated replacement cost) and the income approach.

3.7 The *IFRS for SMEs* Standard or IPSAS do not have separate dedicated measurement standard or equivalent for fair value and both use a different definition of fair value from that included in paragraph 3.6. IPSAS 17 establishes that the fair value of a property is usually determined by market-based evidence by appraisal. The *IFRS for SMEs* Standard uses a hierarchy to estimate fair value based on market prices. Both the IASB[39] and IPSASB[40] have current projects that are considering the impact of IFRS 13.

3.8 Under IPSAS 17, in cases where there is no market-based evidence of fair value because of the specialised nature of the asset, an entity may estimate fair value using the approaches of reproduction cost, depreciated replacement cost, restoration cost or service units.

3.9 An important part of understanding the value of an asset to a public service entity is the concept of service potential this is described in the IPSASB *Conceptual Framework*[41] as the capacity to provide services that contribute to achieving the

[39] The International Accounting Standards Board has a commenced a review of the *IFRS for SMEs* Standard and in particular to consider updates for standards issued since the last update. This will include IFRS 13 *Fair Value Measurement*.

[40] The International Public Sector Accounting Standards Board has recently consulted on measurement across all IPSAS. The IPSASB is considering the definition of fair value as part of its measurement project.

[41] The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities, IPSASB, October 2014.

entity's objectives. The 'value in use' measurement is more likely to reflect the value of services supported and thus its service potential for an entity.

Impairment

3.10 IAS 36 *Impairment of Assets* requires that an assessment is made at the end of each reporting period whether there is any indication that an asset may be impaired. It provides a list of indicators of impairment to assist with this assessment. If there is an indication that an asset may be impaired, then the asset's recoverable amount must be estimated. The recoverable amount is the higher of an asset's fair value (less costs of disposal), and its value in use.

3.11 IPSASB has issued two standards on impairment IPSAS 26 *Impairment of Cash Generating Assets* (based on IAS 36) and IPSAS 21 *Impairment of Non-Cash Generating Assets* drafted for public sector circumstances. IPSAS 21 defines recoverable amount as the higher of a non-cash-generating asset's fair value (less costs to sell) and its value in use, with value in use being the present value of the asset's remaining service potential.

4. National-level guidance[42]

4.1 National-level guidance is consistent with either the IFRS Standards or IPSASB requirements for initial recognition and measurement, subsequent measurement and impairment. Therefore, the reporting requirements depend on the framework adopted. One jurisdiction follows the IPSAS approach but augments this with guidance on the estimation of fair value using the depreciated replacement cost method which is used frequently by public benefit entities.

4.2 One jurisdiction does not permit the revaluation model. In this GAAP, as with IFRS Standards, an asset is impaired if an asset or a group of assets' carrying amount is more than its recoverable amount. The recoverable amount is measured at the undiscounted future cash flows that are directly associated with and that are expected to arise as a result of the use and the eventual disposition of the asset or the asset group.

4.3 In this jurisdiction the impairment of fixed assets for NPOs normally follows the same accounting treatment as commercial entities with one exception, which, rather than establishing a non-cash-flow focused recovery test to determine whether an item of property, plant and equipment is impaired, discusses how contribution subsidies would be factored into a cash-flow focused test.

4.4 Another jurisdiction generally follows the *IFRS for SMEs* Standard initial and subsequent measurement. It is similar on impairment and sets out that if (and

[42] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

only if) the recoverable amount of an asset is less than its carrying amount, an entity is required to reduce the carrying amount of the asset to its recoverable amount. That reduction is an impairment loss. The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use.

4.5 This jurisdiction's standards specifically include the concept of service potential in the measurement of the value in use when measuring the recoverable amount and states:

> "*For assets held for their service potential, a cash flow driven valuation (such as value in use) may not be appropriate. In these circumstances value in use (in respect of assets held for their service potential) is determined by the present value of the asset's remaining service potential plus the net amount the entity will receive from its disposal.*"

5. Alternative financial reporting treatments

5.1 The measurement of property, plant and equipment is consistent across standards regarding initial recognition; historical cost for assets purchased or constructed and fair value for donated assets. These provisions therefore feature in all alternatives. There are, however, different approaches that can be taken to their subsequent measurement and impairment. The alternatives focus on these potential differences.

5.2 The alternatives are based on national and international standards. This includes one jurisdiction that does not allow the revaluation model to be used. The use of the cost model is included in all alternatives noting it may have limitations for presenting information on the use of an asset for service provision.

5.3 **Alternative 1** follows existing international standards (IFRS Standards, the *IFRS for SMEs* Standard and IPSAS), permitting either the cost or revaluation model for subsequent measurement. It includes additional guidance for NPOs, particularly on impairment. The measurement bases available would be those permitted in the relevant standards.

5.4 **Alternative 2** follows existing international standard as alternative 1, but permits the use of an additional measurement base, 'value in use' within the revaluation model. This would allow the concept of service potential available in IPSAS to be applied to all classes of assets.

5.5 **Alternative 3** would not allow the revaluation model and would require all property, plant and equipment to be subsequently measured using the cost model. In this model the fair value determined for donated assets would be used as a proxy for historical cost. This would be an amendment to all three

international accounting frameworks. Disclosures of an alternative value would not be required as this imposes the additional cost of valuation.

5.6 **Alternative 4** mandates the use of the revaluation model (and a 'value in use' measurement) for land and buildings to ensure that the asset's measurement reflect the operational capacity rather than the financial capacity of the asset.

5.7 Revaluation using a 'value in use' could be appropriate for this class of assets reflecting the value an NPO would derive for the provision of specific services such as medical treatment, refuge centres, youth centres, etc. This approach uses the valuation approaches in IPSAS. All other classes of assets would retain the choice, with value in use available where the revaluation model is chosen.

	Description	Advantages	Disadvantages
Alternative 1 Subsequent measurement of property, plant and equipment follows either the cost model or the revaluation model, with additional NPO-specific guidance.	• Initial measurement at historical cost. • Donated assets to be measured initially at fair value and subsequently in accordance with the relevant class of property, plant and equipment. • For subsequent measurement, provide NPOs with the choice to value classes of assets using the cost or the revaluation model. • Where assets are subject to impairment, they should be measured at the lower of carrying value and recoverable amount. • Provide additional NPO-specific guidance, particularly to assist with impairment reviews.	**Technical** • Follows existing international standards. **Practical** • Additional guidance to show how the principles apply. **Stakeholder information** • NPOs will be able to choose the model in accordance with the needs of their users and which best represents the measurement of its assets. • Provides transparency about the cost of the use of assets for service provision where the revaluation model is used. **Cost/benefit** • Allows NPOs to choose the most cost-effective option. • No change to existing arrangements and therefore should be cost neutral.	**Stakeholder information** • Where an NPO chooses to use the cost model, this may limit the usefulness of information particularly in demonstrating the value of its use to an NPO for the provision of services. • Comparability may be limited if similar organisations use different models. **Cost/benefit** • Revaluation may increase depreciation charges.

	Description	Advantages	Disadvantages
Alternative 2 Subsequent measurement of property plant and equipment follows either the cost model or the revaluation model and includes an additional measurement base (value in use) under the revaluation model – with additional NPO-specific guidance on how to measure the service potential in those assets to be measured at 'value in use'.	• Initial measurement at historical cost • Donated assets to be measured initially at fair value and subsequently in according with the relevant class of property, plant and equipment. • For subsequent measurement provide NPOs with the choice to value classes of assets using the cost or the revaluation model. Alongside fair value measurement, allow for another measurement base, 'value in use' so that NPOs can measure the service potential of assets from which they provide services. • Where assets are impaired, they should be measured at the lower of carrying value and recoverable amount. • Provide additional NPO-specific guidance, particularly to assist with impairment reviews.	**Practical** • Additional guidance to show how the principles apply. **Stakeholder information** • Allows assets to be valued to reflect their service potential so that users understand the resources consumed in the use of assets by the services or activities provided. • NPOs will be able to choose the model in accordance with the needs of their users and which best represents the measurement of its assets. **Cost/benefit** • Allows NPOs to choose the most cost-effective option.	**Technical** • Value in use is not used explicitly in international standards (but discussed in both IASB and IPSASB Conceptual Frameworks) so, aligned with alternative 4 financial reporting and/or regulatory frameworks may not allow measurement at 'value in use'. **Practical** • Difficulty in providing guidance on the measurement of service potential across different types of NPOs. **Stakeholder information** • Where an NPO chooses to use the cost model, this may limit the usefulness of information particularly in demonstrating its use to an NPO for the provision of services. • Comparability may be limited if similar organisations use different models. **Cost/benefit** • Revaluation may increase depreciation charges.

	Description	Advantages	Disadvantages
Alternative 3 Subsequent measurement of property plant and equipment using the cost model – with additional NPO-specific guidance	• Initial measurement at historical cost. • Donated assets to be initially measured at fair value (as an estimate of historical cost). • Subsequent measurement using the cost model. • Where assets are impaired, they should be measured at the lower of carrying value and recoverable amount. • Provide additional NPO-specific guidance, particularly to assist with impairment reviews.	**Practical** • Additional guidance to show how to apply the principles. **Stakeholder information** • Relatively simple and may be more easily understood by stakeholders and donors. • Allows for comparability. **Cost/benefit** • More cost effective to produce.	**Technical** • Lack of choice is not consistent with international accounting standards • Increases in the value of an asset are not recognised in historical cost measurements **Stakeholder information** • Does not offer a choice about how to best represent the value of the assets. • May not fully present information about the operating capacity of the assets to support service delivery.
Alternative 4 Require certain classes of assets where they are used for their service potential to be measured using the revaluation model at a 'value in use' measurement basis. For the remaining classes of assets (plant and equipment) allow a rebuttable presumption that assets measured at historical cost is a proxy for the revalued asset.	• Initial measurement at historical cost. • Donated assets to be measured initially at fair value and subsequently in accordance with the relevant class of property, plant and equipment. • Require classes of property to be measured using the revaluation model at a 'value in use' measurement base where those assets are used to provide services. Allow a rebuttable presumption that the classes of plant and equipment are measured at historical cost as a proxy for the revalued asset. • Where assets are impaired, they should be measured at the lower of carrying value and recoverable amount. • Provide additional NPO-specific guidance, particularly to assist with impairment reviews.	**Technical** • Assets values reflect the operational capacity of the most material assets. **Practical** • Additional guidance to show how to apply the principles should promote consistency and ease of application. **Stakeholder information** • Improves users' understanding of resources consumed by allowing assets most materially impacted by revaluation to be valued to reflect their service potential. • Allows comparison of performance between NPOs on one class of assets, which will be useful for decision making purposes for donors and other stakeholders.	**Technical** • Value in use is discussed in both the IASB and IPSASB Conceptual Frameworks but not explicitly defined. **Practical** • NPOs may not have the resources or skills to commission valuations. **Stakeholder** • Comparability may be limited if similar organisations use different models for other asset classes. **Cost/benefit and technical** • Likely to be costly and increase the reporting burden, particularly for smaller NPOs. • May increase depreciation charges.

Specific Matters for Comment 5

5.a Do you agree with the description of issue 5: Measurement of non-financial assets held for service benefit? If not, why not?

5.b Do you agree that the list of alternative treatments that should be considered for issue 5 is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.

5.c Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 5? If you do not agree, please set out the changes you propose, and why these should be made.

5.d Please identify the alternative treatment that you favour for issue 5, and the reasons for your view.

5.e Do you agree that land and buildings (or sub classifications thereof) used to provide services should be measured using the revaluation model and specifically a measurement which reflects the 'value in use' or the operational capacity to an NPO? Could it provide useful information to users?

Issue 6: Inventory held for use or distribution

1. Description of the issue

1.1 **NPOs hold a wide variety of inventory**. Examples include medical supplies, textbooks, food, clothing, fuel, furniture, equipment, and leaflets. NPOs may hold inventory for commercial purposes, for example, items held for sale in shops to generate revenue to support the work of an NPO. NPOs may also hold inventory to be used directly in meeting their objectives. Such inventory may be held for direct distribution to service users or may be held for use by an NPO in delivering services.

Measurement

1.2 **NPOs will need to determine which costs should be included in the carrying amount of own produced inventory**. An NPO may produce the inventory itself, taking raw materials and developing them into a finished product, for example using paper and inks to produce information leaflets. In such examples NPOs will need to determine their materiality and have processes to measure stock levels.

1.3 **NPOs may not have inventory management systems that allow them to record low value/high volume inventories and it may be impractical to do so**. NPOs can receive donations of low value/high volume inventories provided for resale. They may have difficulty in both keeping records of items and assigning a value to each item.

1.4 **Donations that are intended for onward distribution to service users may only have a value for a short period**. For example, pharmaceutical organisations can donate vaccinations to be used as part of aid programs, or food can be donated to provide meals for the homeless. These kinds of donations can be made when the item being donated needs to be used within a defined period because it has a short expiry date. While it might be easier to keep records for these items it may not be possible for an NPO to estimate whether they can all be used.

1.5 **NPOs may be part the way through the provision of services and have work in progress** usually included in inventories. An example would be where an NPO prepares legal casework to support refugees and asylum seekers. Until a case is heard, the casework may meet the recognition criteria for inventory. Unless record keeping systems (such as timesheets) are in place, NPOs may find it difficult to determine the cost of these items of inventory.

1.6 **It may be impractical to maintain records of inventory movements for all items**. The value of inventory, whether held for sale or held for use or distribution, will need to be updated as new inventory is added or as inventory

is sold, distributed, or used. For some items of inventory (eg services such as pro-bono legal work) individual values may be recorded, but for other items this may not be practicable or possible. For example, where an NPO stores all its fuel in a tank, it will not be possible to separately identify the fuel that relates to a particular delivery. Where individual records are not appropriate, a costing formula will need to be used. Formulas that are commonly used are first in, first out (FIFO) and weighted average.

1.7 **NPOs may not be able to demonstrate the value that comes from donations and the need for them to continue** because of difficulties in measuring some items of inventory. These difficulties may lead to differences between NPOs in how inventory is reflected in financial statements. Stakeholders may find it difficult to understand how an NPO is delivering its services if an NPO does not record donated inventory.

2. Financial reporting challenges

2.1 **There are no issues that are unique to NPOs for purchased inventory**. Where an NPO acquires inventory by purchasing the inventory itself, the cost of the inventory will be straightforward to determine. While there may be challenges for some NPOs in determining the cost of own produced inventory, issues are unlikely to be unique to NPOs.

Recognition

2.2 **If the cost of an item cannot be measured reliably, then no inventory (asset) is recognised**. Items of inventory are normally recognised as assets in the balance sheet and initially measured at cost, provided that their cost can be measured reliably. If items are not recognised as inventory (assets) in the balance sheet, this will impact how the use of the items are recognised (expense) and the value of the donation provided (revenue). This is considered in issue paper 3 on non-exchange revenue.

Initial measurement

2.3 **There are more significant challenges in reliably measuring the cost of donated items as there is no purchase cost**. Instead, the fair value of the items is used as their deemed cost when recognising inventory (assets). For an NPO to be able to reliably measure the deemed cost (fair value) of the items that have been donated it needs to know the date that it took control of each item, and be able to determine a reliable estimate of its value at this date. If an NPO cannot obtain a reliable measurement it may not be able to recognise the item as inventory in its balance sheet.

2.4 **It may not be possible to recognise donations for resale as inventory in the balance sheet when they are received**. Items donated for resale can be high in volume and low in value. As is discussed in issue paper 3 on non-

exchange revenue, it may be possible to recognise revenue at a later date if the items are sold. There is also the question of whether/how to account for donations that are not suitable for resale; if these have been recognised as inventory, it may be necessary to impair the items.

2.5 **An estimate of the value of the inventory may be too uncertain to be reliable**. It may be difficult to prepare a reliable estimate of the fair value of items donated for distribution to service users or for an NPO's own use (including for administrative purposes). Practical difficulties can arise in determining whether all of the items donated have a value, even if the value of each item is known, because the uncertainties over usage.

2.6 **Assessing the fair value of the items may impose costs or administrative burdens** on some NPOs. Some NPOs may find the keeping of inventory records challenging, particularly if they do not have an inventory control system. The cost of assessing the fair value might be disproportionate to the value of the item and exceed the benefit derived from being able to recognise the items as inventory.

2.7 **An alternative method of assessing the value of the inventory may be required**. The value to the entity of inventory held for commercial purposes (for example, greetings cards purchased for resale) can be assessed by reference to the expected sales proceeds. However, there may be no, or nominal, sales proceeds associated with other inventory held for use or distribution.

Subsequent measurement

2.8 **Determining subsequent values for types of inventory (whether this value derives from sales, distribution, or use) may be challenging**. After initial recognition, inventory is subsequently measured to ensure that its value does not exceed the value that can be obtained from the inventory. If items are not recognised as inventory in the balance sheet, then no issues of subsequent measurement will arise.

Impairment

2.9 **Inventory will need to be written down (impaired), where the carrying amount of the inventory exceeds its value to the entity**. Impairing inventory relies on being able to determine the value to the entity. For similar reasons to those relating to recognition and initial measurement, this may also create a financial reporting challenge.

3. Current international guidance

3.1 Currently international guidance on the measurement of inventory held for use or distribution is included in the following standards:

- IAS 2 *Inventories*
- Section 13 the *IFRS for SMEs* Standard
- IPSAS 12 *Inventories.*

Measurement

3.2 IAS 2 and Section 13 of the *IFRS for SMEs* Standard require inventory to be measured initially at cost, and subsequently at the lower of cost and estimated selling price less costs to complete and sell (also referred to as net realisable value). Entities are required to assess whether the cost of the inventory exceeds its estimated selling price less costs to complete and sell at each reporting date. Where the cost is greater than the estimated selling price less costs to complete and sell, the inventory is written down to the estimated selling price less costs to complete and sell. The *IFRS for SMEs* Standard refers to this as impairment, but the process is the same in both IAS 2 and the *IFRS for SMEs* Standard.

3.3 IPSAS 12 has similar requirements; however, IPSAS 12 does not apply to work-in-progress of services to be provided for no or nominal consideration. Entities are required to develop their own accounting policies for such transactions, for example, expense the work as it is undertaken.

3.4 The measurement requirements in IPSAS 12 are the same as IAS 2. IPSAS 12 is more explicit in its requirements in two areas. Donated inventory is initially measured at fair value (this is discussed in issue paper 3 on non-exchange revenue). Inventory held for use or distribution is subsequently measured at the lower of cost and current replacement cost.

3.5 IAS 2, Section 13 of the *IFRS for SMEs* Standard and IPSAS 12 provide guidance on the elements of the cost of inventory, and on allocating overheads. Fixed overheads are allocated based on normal capacity; variable overheads are allocated based on actual usage. They permit the use of techniques such as the standard costing method or the retail method where these approximate to cost.

3.6 Where items of inventory are not valued individually, IAS 2, Section 13 of the *IFRS for SMEs* Standard and IPSAS 12 require the use of either the FIFO or weighted average cost formulas. The last in first out formula (LIFO) is not permitted.

Impairment

3.7 Under IAS 2, Section 13 of the *IFRS for SMEs* Standard and IPSAS 12, the value of inventory is assessed at the end of the reporting period. Where the value of inventory is below its cost, it is written down to its selling price less costs to complete and sell (or, in the case if inventory held for use or distribution under IPSAS 12, its current replacement cost). The amount of the write-down, which is referred to as the impairment loss in the *IFRS for SMEs* Standard, is recognised as an expense.

4. National-level guidance[43]

4.1 While national-level guidance and standards can be converged on IFRS Standards, the *IFRS for SMEs* Standard or IPSAS, or set independently of international standards, there is consistency on the core principles around accounting for inventory. There are, however, differences between jurisdictions about the measurement of inventory held for use or distribution. Issue paper 3 on non-exchange revenue provides additional information about approaches taken by national standard setters to donated inventory.

4.2 One jurisdiction is based on IAS 2, with some amendments for non-profit entities. This national standard does not apply to work-in-progress of services to be provided for no or nominal consideration. Guidance is provided for measuring donated inventory. Inventories held for use or distribution are measured at cost, adjusted (ie impaired) when applicable for any loss of service potential. The guidance notes that for many items of inventory, "a loss of service potential would be identified and measured based on the existence of a current replacement cost that is lower than the original acquisition cost or other subsequent carrying amount." Where inventory is acquired in a non-exchange transaction, current replacement cost is used as the cost of the inventory.

4.3 One jurisdiction has a standard based on the *IFRS for SMEs* Standard, with some amendments. Guidance is provided for measuring donated inventory. Inventories held for use or distribution are measured at the lower of cost, adjusted (impaired) when applicable for any loss of service potential and replacement cost.

4.4 One jurisdiction has a standard is based on IPSAS 12 with guidance provided for measuring donated inventory. Unlike IPSAS 12, inventory held for use or distribution is measured at cost, adjusted (impaired) when applicable for any loss of service potential.

4.5 One jurisdiction has issued a general standard on inventories that is not based on international standards but is broadly consistent with IAS 2 and the *IFRS for*

[43] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

SMEs Standard. This standard setter has also issued a separate standard on inventories held by non – profit organisations. This standard includes guidance on donated inventories. Inventories held for use or distribution are measured at the lower of cost and current replacement cost (in other words, inventory is impaired when the current replacement cost is lower than the cost of the inventory).

4.6 One jurisdiction has a standard that is not based on international standards but is broadly consistent with IAS 2 and the *IFRS for SMEs* Standard, although it permits the use of the last in first out (LIFO) costing formula, albeit with specific impairment provisions. The scope of the standard does not provide any specific guidance for NPOs.

5. Alternative financial reporting treatments

5.1 Both international and national accounting standards adopt similar principles for accounting for inventories. Differences between the standards relate to whether specific provisions are required for donated assets, the application of the standard to work-in-progress of services provided at no cost, and the measurement (impairment) of inventory held for use or distribution. The initial measurement of donated inventory is considered in issue paper 3 on non-exchange revenue.

5.2 Some standards do not include specific guidance on the measurement (impairment) of inventory held for use or distribution. Where guidance is included, the two approaches adopted are to measure inventory at the lower of cost and current replacement cost; and to measure inventory at cost, adjusted when applicable for any loss of service potential. In some cases, a loss of service potential will be indicated by a current replacement cost that is lower than cost, so there is some overlap in the approaches adopted in the standards. These approaches have informed the development of the alternative approaches in this issue paper.

5.3 Measuring work-in-progress of services to be provided at no cost may be challenging for some NPOs. For this reason, the alternative approaches that include specific provisions for inventory held for use or distribution permit such work-in-progress to be expensed as incurred.

5.4 **Alternative 1** is based on the requirements of IFRS Standards (IAS 2) and the *IFRS for SMEs* Standard, with additional guidance for NPOs, but no divergence from the requirements of these standards. This guidance could cover situations where it may be more practical for NPOs to apply general materiality principles and expense items as they are acquired.

5.5 **Alternative 2** is based on the requirements of IPSAS (IPSAS 12) and allows work in progress for no or nominal consideration to be expensed and provides

for inventory for distribution to be valued at the lower of cost and current replacement costs, with additional guidance for NPOs.

5.6 **Alternative 3** is based on the requirements of IPSAS 12 (as alternative 2) but requires that inventory for distribution is valued at the lower of cost and current service potential. This valuation technique is not permitted by any current international standards but is required by one jurisdiction as part of its national standards. As with alternatives 1 and 2, additional guidance would be provided.

5.7 Under all three alternatives, NPOs face a practical issue in that they may not have the systems needed to capture all inventory.

	Description	Advantages	Disadvantages
Alternative 1 Measure all inventory at the lower of cost or net realisable value with additional NPO-specific guidance.	• Inventory measured at the lower of cost or selling price (less costs to complete). • No specific provisions for the measurement of donated inventory and inventory held for use or distribution. • Additional NPO-specific guidance and examples on applying the general provisions for inventory; on measuring inventory held for use or distribution; and on when inventory could be expensed as acquired on materiality grounds.	**Technical** • Fully compliant with IFRS Standards and the *IFRS for SMEs* Standard. **Practical** • Specific guidance may assist NPOs in their potentially complex arrangements. **Cost/benefit** • Guidance may assist in cost of preparation.	**Practical** • Challenge of determining materiality. **Stakeholder** • The writing down of inventory held for distribution to zero may obscure transparency unless the service potential (eg replacement cost) is disclosed. **Cost/benefit** • Measuring work-in-progress of services to be provided at no cost and inventory held for use or distribution may be costly.
Alternative 2 Require inventory held for use or distribution to be measured at the lower of cost or current replacement cost **.**	• Inventory held for use or distribution is measured at the lower of cost or current replacement cost. • No specific provisions for the measurement of donated inventory. • Permit work-in-progress of services to be provided at no or nominal cost to be expensed as incurred. • Additional NPO-specific guidance and examples on applying the general provisions for inventory; and on when inventory could be expensed as acquired on materiality grounds.	**Technical** • Fully compliant with IPSAS. • Current replacement cost is more appropriate than estimated selling price where inventory is not sold. **Practical** • Specific guidance may assist NPOs in their potentially complex arrangements. **Stakeholder** • Provides a consistent approach to measuring inventory held for use or distribution. **Cost/benefit** • Guidance may assist in considering cost/benefit of approaches.	**Technical** • May not be consistent with IFRS Standards and the *IFRS for SMEs* Standard. **Practical** • Current replacement cost may be difficult to determine where donated. **Stakeholder** • May lead to inconsistent treatment of work-in-progress of services to be provided at no or nominal cost. • Transparency may be impacted without disclosures on inventory not recognised in the financial statements.

	Description	Advantages	Disadvantages
Alternative 3 Require inventory held for use or distribution to be measured at cost, adjusted when applicable for any loss of service potential, with disclosure of the accounting policy and impact on service delivery.	• Inventory held for use or distribution is measured at cost, adjusted when applicable for any loss of service potential. • Permit work-in-progress of services to be provided at no or nominal cost to be expensed as incurred. • Require disclosure relating to the calculation of the loss of service potential, (including where this reduces service potential to zero) and the significance to the meeting of organisational objectives. • Additional NPO-specific guidance and examples on applying the general provisions for inventory; and on when inventory could be expensed as acquired on materiality grounds.	**Practical** • Adjusting cost for loss of service potential (eg obsolescence) may be easier to determine than current replacement cost. **Stakeholder** • Provides a consistent approach to measuring inventory held for use or distribution. • More relevant information for stakeholders • Improved transparency about the impact on service delivery. **Cost/benefit** • Guidance may assist in considering cost/benefit of approaches.	**Technical** • May not be consistent with IFRS Standards, the *IFRS for SMEs* Standard and IPSAS. **Practical** • Determining service potential may be challenging. **Stakeholder** • May lead to inconsistent treatment of work-in-progress of services to be provided at no or nominal cost. • Differing assessments of loss of service potential may lead to inconsistent treatments and obscure transparency.

Specific Matters for Comment 6

6.a Do you agree with the description of issue 6: Inventory held for use or distribution? If not, why not?

6.b Do you agree that the list of alternative treatments that should be considered for issue 6 is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.

6.c Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 6? If you do not agree, please set out the changes you propose, and why these should be made.

6.d Please identify the alternative treatment that you favour for issue 6, and the reasons for your view.

Section 5: Presentation, content and scope of financial reports

Section 5: Presentation, content and scope of financial reports

Earlier research identified that additional information would help with the understanding of accounts and the presentation of the accounts themselves could be improved. Topics included the reporting of remuneration, related party transactions and foreign currency transactions (which are not prioritised for inclusion in the initial guidance), as well as the presentation of financial statements and narrative reporting, which are considered further below. This section also includes the classification of expenses and fundraising costs, which are primarily concerned with the presentation of financial information.

Issue 7 – Financial statement presentation

The format and content of financial statements including revenue and expenses is fundamental to how the information is presented to stakeholders. This presentation is particularly important when revenue is restricted or can only be used for particular purposes.

Some of the specific questions that this topic is seeking to address are:

- How should financial statements be presented to help the user's understanding of an NPO's activities? Should there be disclosure of material categories of income and expenses and/or transactions?
- How should unrestricted and restricted funds that can be used for specific NPO purposes be presented in the main financial statements and notes (including reserves)? How does this align with donor reporting requirements? What is the role of fund accounting?

Issue 8 – Classification of expenses – function or nature

NPOs can present their expenses by nature or by function, with at least one jurisdiction a presentation allowing a hybrid of the two.

Some of the specific questions that this topic is seeking to address are:

- Should there be a standardised format and if so, what should the primary headings be?
- Should the primary analysis of expenses be based on function or nature?

Issue 9 – Fundraising costs

Raising funds is critical to the existence of many NPOs. They can take many forms and there is a question about where to report the costs of doing so.

Some of the specific questions that this topic is seeking to address are:

- How should the costs of fund raising be defined (for example, whether to include business development spend and/or overheads)?
- How should the costs of fundraising be recognised and/or presented (ie on a gross basis or netted against income)?

Issue 10 – Narrative reporting

Non-financial information, which includes management commentary and other forms of narrative reporting, is relevant to NPOs, in demonstrating accountability and stewardship to stakeholders and civil society. For many NPOs, the financial statements may not capture many of the most important aspects of its performance.

Some of the specific questions that this topic is seeking to address are:

- What should the narrative/non-financial reporting requirements be for NPOs?
- Should ratios be required for narrative reporting? If they are included, how should costs be classified between support costs and those attributable to operational delivery?

Issue 7: Presentation of financial statements (including fund accounting)

1. Description of the issue

1.1 **The financial statements provide information to a wide range of stakeholders**. They provide information about an NPO's financial performance, financial position and cash flows, are a key document for holding an NPO to account, and for making economic decisions.

1.2 **It may not be clear which resources and reserves reported in the financial statements can be used by an NPO for its ongoing activities**, and which can only be used in relation to the purposes for which they were given. The nature of NPOs and the way many NPOs are funded raise some unique financial reporting issues. These impact the content and the presentation of financial statements. In particular, the fact that NPOs receive funding that has conditions or restrictions (stipulations) attached may mean that an NPO is not free to use its resources as it wishes. This may be relevant to stakeholders' understanding of the financial statements.

1.3 **Some donations may be in the form of an endowment, which must be invested**. While an NPO can use the interest earned from the investment, the capital itself cannot be used by an NPO. Again, this limitation may not be clear from the financial statements.

1.4 **Stakeholders may have different views about what information should be included in the financial statements**. Some donors may be looking for information in a particular format. For example, a donor that has provided funding with a condition may wish to see a statement that shows the cash received from the donation and the cash payments made with that donation, which goes beyond the information included in most financial statements. Information about the cash receipts and payments in respect of individual donations is not usually visible in financial statements.

1.5 **Donors may be seeking additional information that supports their assessment of the use of the donations**. This may be a particular issue where the donation is only intended to cover part of a project's costs. Donors may be seeking information about expenses that have been committed but not yet incurred, and which is therefore not yet recognised in the financial statements. Additionally, donors who permit services in-kind received by an NPO to count against the total cost of a project may be unable to confirm these amounts, even if such amounts are recognised in the financial statements.

1.6 **NPOs may have difficulty in knowing when it is appropriate to create separate reserves and how to manage them**. Some funds or reserves

may only be used for specific purposes because of restrictions imposed by the donor. In other cases, NPOs may decide to set aside other amounts for specific purposes for internal management reasons. This includes setting aside amounts to create capacity to deal with unforeseen events or emergencies, or to purchase capital assets. Reporting significant transfers between reserves may obscure an NPO's performance, particularly if funds are transferred to reserves in years when there is a surplus but withdrawn and used for an NPO's ongoing operations if there is a deficit in the year.

2. Financial reporting challenges

2.1 **General purpose financial statements are necessarily an aggregation of an entity's transactions.** Financial statements result from processing large numbers of transactions or other events that take place in a financial reporting period. It is highly unlikely that an individual transaction is identifiable in the financial statements.

2.2 **Attempting to provide all the information stakeholders may wish to see in the financial statements may lead to complex, costly requirements**. Providing varying perspectives on the same transactions may also confuse users of the financial statements. It will be necessary to consider the extent to which stakeholder's differing views can be accommodated in general purpose financial statements that are intended to meet the needs of many stakeholders. General purpose financial statements are generally prepared from the reporting entity's perspective. Balancing the competing needs of different stakeholders must be considered.

2.3 **Stakeholders will be seeking a range of information about an NPO's financial and non-financial performance**. The focus of this issue paper is on the general-purpose financial statements that contain financial performance information. Part 1 of this Consultation Paper discusses the users of the financial statements, and the reporting entity, and this issue paper should be read in the light of those discussions. Non-financial information is considered in issue paper 10 on narrative reporting.

2.4 **Separating funds that distinguish between the net assets that are restricted for a particular purpose and those that can be used for any purpose could provide greater transparency.** Some assets may need to be used for particular purposes and others at the discretion of an NPO. The nature of the different types of funds that make up an NPO's net assets provide a financial reporting challenge.

2.5 **Maintaining separate financial statements for each type of fund or reserve (fund accounting)** could address this problem. Presenting each fund or reserve may be feasible where an NPO has a very limited number of restricted funds. However, as the number of funds increases, so will the

complexity of the financial statements, which may make them more difficult to understand. Financial statements could become larger in volume, which could be mitigated if funds are aggregated into similar types of fund or reserve in the financial statements. While this may increase transparency, it could increase the costs for NPOs. Consideration may also need to be given as to whether some funds are separate reporting entities.

2.6 **It may be more difficult to provide a fund presentation with some financial statements.** The income statement generally lends itself to a fund presentation. The financial position statement (balance sheet) could show the fund balances separately; but presenting fund balances for assets and liabilities could be far more challenging.

2.7 **Stakeholder needs could be meet by a cashflow that shows the source and application of funds**. The preparation of a cash flow statement separated by fund (analysing receipts and payments for each fund) could meet the needs of stakeholders who want to understand what has happened to their donation. It would require all cash receipts and payments to be recorded by fund, which may be challenging because of system limitations, cost and effort. There is also the question of whether this is appropriate for general purpose financial statements that are intended to be used by a wide range of stakeholders.

2.8 **Disclosing the accounting treatment for donations that have conditions could assist users**. Some donors may expect an NPO to recognise revenue for the donations that they have made and may be confused if they are not able to see this revenue in the income statement. Users may not understand that, where a donation has a condition, a liability will have been recognised and the revenue deferred.

2.9 **Timing issues could be explained in the notes to the financial statements**. Where a donation has been recognised in one financial year, but the related expense does not happen until a subsequent financial year, users may not understand the misalignment between these transactions.

2.10 **Reserve management is primarily a financial management issue**, however, disclosure of an NPO's policies on reserves may help stakeholders understand management's decisions. If an NPO decides to set aside other amounts for specific purposes for internal management reasons, reporting these separately from an NPO's other finances can provide greater transparency about an NPO's operations and the amounts available to fund its ongoing operations. NPOs may find it helpful to have guidance on when reserves should be created and how they should be managed.

3. Current international guidance

3.1 Currently international guidance on the presentation of financial statements is included in the following standards:[44]

- IAS 1 *Presentation of Financial Statements*[45]
- IAS 7 *Statement of Cash Flows*
- Sections 3 – 8 the *IFRS for SMEs* Standard[46]
- IPSAS 1 *Presentation of Financial Statements*
- IPSAS 2 *Cash Flow Statements*

3.2 Under IFRS Standards and the *IFRS for SMEs* Standard, a complete set of financial statements includes the following: statement of financial position; income statement (either a statement of comprehensive income, or separate income statement and comprehensive income statement); statement of changes in equity; statement of cash flows: and notes to the financial statements. The statement of cash flows may be presented using the direct or the indirect method.

3.3 These standards provide that, in these statements, assets, liabilities, income and expenses should be broken down into material categories, with such information needed to give stakeholders a full picture of an entity's financial position and performance.

3.4 IPSAS uses some different terminology, but otherwise has similar requirements. One difference is that the income statement (the statement of financial performance) in IPSAS does not include other comprehensive income. The gains and losses presented in other comprehensive income under IFRS Standards or the *IFRS for SMEs* Standard are presented in the statement of changes in net assets/equity under IPSAS.

3.5 IFRS Standards, the *IFRS for SMEs* Standard and IPSAS include guidance on the format of each statement such as the material categories of assets and liabilities to be reported. They also include further guidance on topics such as comparative information, materiality, and the aggregation or disaggregation of information. The examples in these standards present the statement of financial position (the balance sheet) using a vertical presentation. Under this presentation, assets are presented first, with liabilities below assets, followed

[44] Other standards also include presentation and disclosure requirements. These are not included in the discussion of this topic.

[45] The IASB has issued Exposure Draft ED/2019/7 *General Presentation and Disclosures* that proposes amendments to the format and content of the financial statements to be presented under IAS 1. Some changes to IAS 7 are also proposed.

[46] The International Accounting Standards Board has initiated a programme to review the *IFRS for SMEs* Standard and in particular to consider updates for IFRS standards issued since the last update.

by net assets (or equity). However, the standards do not prohibit a horizontal presentation, with assets presented alongside liabilities and net assets (equity).

3.6 These standards do not include any guidance on the issues raised in section two of this issue paper. There is no guidance on fund accounting or the presentation of fund or reserve balances. While the international standards do not prohibit additional information and subtotals being included on the face of the financial statements, no guidance is provided. Each preparer currently needs to use their own judgement in determining an appropriate format for each financial statement.

4. National-level guidance[47]

4.1 Where jurisdictions follow international standards, the principles established in section three of this issue paper above largely apply in national standards. Three jurisdictions have standards based on international standards (one based on IFRS Standards, one based on the *IFRS for SMEs* Standard and one based on IPSAS). While these jurisdictions may have some modifications for NPOs (such as reduced disclosure requirements) they do not provide additional guidance on all of the issues raised in Section 2. However, the latter two jurisdictions provide additional guidance that addresses these issues in part.

4.2 The jurisdiction that uses the *IFRS for SMEs* Standard provides sector specific guidance for NPOs. NPOs are required to use fund accounting in their financial statements. In presenting the financial statements, funds are aggregated into three classes – unrestricted funds, restricted income funds and restricted endowment funds. Restricted income funds are those funds where an NPO receives funds that the donor requires to be used for a particular purpose. Endowment funds are those funds where the capital is to be invested, with an NPO using the interest (either for a specific purpose or for its ongoing activities). The guidance notes that, while some unrestricted funds may be designated for a specific purpose, because this is an internal decision (that can be reversed), the funds remain unrestricted.

4.3 In the income statement, columns show the income and expenditure for each class of fund. The three classes of funds are shown in the statement of financial position, with a columnar presentation permitted but not required. Transfers between funds are included in the income statement. Transfers may occur where, for example, a fixed asset is purchased from a restricted fund but is to be used for non-restricted purposes; or where the restriction on a fund expires and the funds become unrestricted.

[47] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

4.4 The jurisdiction whose standards are based on IPSAS issues simplified requirements for smaller NPOs. These requirements provide guidance on the difference between restricted and unrestricted funds (referred to as reserves); however, the minimum reporting requirement is that an aggregated figure for reserves is presented in the statement of financial position. The cash flow statement uses the direct method.

4.5 Two jurisdictions have developed national standards that are not based on international standards. The first requires net assets with donor restrictions and net assets without donor restrictions to be presented separately. These are equivalent to restricted funds and unrestricted funds. In the income statement, income with donor restrictions is shown separately from income without donor restrictions. Expenditure is shown as a decrease in net assets without donor restrictions; where an NPO satisfies the conditions imposed by the donor, the net assets are reclassified as net assets without donor restrictions.

4.6 The second permits, but does not require, the use of fund accounting in presenting the financial statements. A statement of changes in net assets is required. The different classes of net assets to be presented are: endowments; internally restricted net assets; externally restricted net assets (other than endowments); and unrestricted net assets.

4.7 This jurisdiction permits the use of two methods of presenting restricted contributions (incoming cash transfers and gifts in-kind). Under the deferral method income is not recognised until the related expense occurs. Under the restricted fund method, restricted contributions for which a corresponding restricted fund is presented should be recognised as revenue of that fund in the current period. Restricted contributions for which no corresponding restricted fund is presented should be recognised in the general fund in accordance with the deferral method. Accounts preparers must select one method and apply it to all contributions.

5. Alternative financial reporting treatments

5.1 All of the alternatives take the minimum requirements of international standards as the starting point. They permit flexibility in the presentation of the financial statements (for example, whether a vertical presentation or horizontal presentation is adopted for the balance sheet). This flexibility is retained in all the alternatives; no prescribed format it proposed. More guidance is proposed in all of the alternatives for NPOs regarding the presentation of net assets (or equity). The presentation approach chosen will depend, at least in part, on how restricted contributions are recognised. The recognition alternatives are discussed in issue paper 3 on non-exchange revenue.

5.2 Some jurisdictions permit the use of either the deferral method or the fund accounting method for presenting restricted contributions. Some jurisdictions also have additional requirements to the international standards. For example, some jurisdictions require or permit NPOs to prepare the income statement (statement of financial performance) on a columnar basis, with a column for each type of fund or reserve. These have informed the development of the alternative approaches.

5.3 All of the alternatives include disclosure of the entity's policy for the management of reserves on the basis that this could improve transparency

5.4 **Alternative 1** is to retain the requirements in the international standards (IFRS Standards, the *IFRS for SMEs* Standard and IPSAS) unchanged and provide supplementary guidance. This guidance could include how additional information would be included in the financial statements when this is relevant for their stakeholders. This could involve disclosures on restricted funds.

5.5 **Alternative 2** is built on the *IFRS for SMEs* Standard and draws on guidance from national standards, specifically the use of fund accounting. The use of fund accounting would require, as a minimum, that income is split between restricted and unrestricted income on the face of the income statement. It could also result in additional disclosure on the face of the statement of financial position or in the notes to the financial statements.

5.6 **Alternative 3** builds on alternative 2 and adds a new requirement to provide supplementary donor or project statements for material funds or projects. This supplementary information could be part of the financial statements or form part of the notes to the accounts and could be on a cash or accrual basis. This goes beyond existing requirements globally and has the potential to meet the reporting needs of major donors.

5.7 The general needs of stakeholders underpin the work of international standard setters in the private and public sectors. The information provided in the financial statements should meet the general information needs of NPO stakeholders, which may differ to the needs of private and public sector stakeholders.

	Description	Advantages	Disadvantages
Alternative 1 Use existing international standards (IFRS Standards, the *IFRS for SMEs* Standard or IPSAS) with additional NPO-specific guidance on the provision of additional information to meet stakeholder needs.	• Additional NPO-specific guidance and examples on optional extensions to the presentation requirements, including presentation of restricted funds, use of fund accounting and use of supplementary fund/project statements. • Recommend the disclosure of policies regarding the management of reserves.	**Technical** • Retains existing presentation of financial statements. **Practical** • Specific guidance to assist NPOs in their potentially complex arrangements and to address materiality and cost/benefit. **Stakeholder** • Allows NPOs to use only those options that are relevant to their stakeholders. • Transparency of earmarked reserves where recommendations are adopted.	**Practical** • NPOs may lack the information or expertise required to determine which options are required to meet the needs of their stakeholders. **Stakeholder** • Less consistency in financial reporting as different NPOs will present varying levels of detail in the financial statements. • May not meet the reporting needs of major donors.
Alternative 2 Use the *IFRS for SMEs* Standard and require NPOs to use fund accounting and disclosure of reserves policy in the preparation of the financial statements, with guidance on additional information to meet stakeholder needs.	• Requirement to report restricted funds separately from unrestricted funds as a minimum. • Requirement to use fund accounting for the income statement and for fund/reserve balances. • Require the disclosure of policies regarding the management of reserves. • Additional NPO-specific guidance on extending fund accounting to other statements and additional funds/ reserves if relevant. • Additional NPO-specific guidance on the use of supplementary fund/project statements if relevant.	**Technical** • Accounting for each fund separately may lead to improvements in financial management. **Practical** • Specific guidance to assist NPOs in their potentially complex arrangements and to address materiality and cost/benefit. **Stakeholder** • Presentation of restricted funds separately from unrestricted funds may increase transparency of available funds. • Transparency on earmarked reserves. • Improved consistency of presentation.	**Practical** • Additional records may be needed. **Stakeholder** • May not meet the reporting needs of major donors. **Cost/benefit** • Cost of introducing fund accounting may exceed the benefits for smaller NPOs, as a consequence of additional analysis. • The cost or preparing and auditing financial statements may increase.

	Description	Advantages	Disadvantages

Alternative 3
Use the *IFRS for SMEs* Standard and require NPOs to use fund accounting in the preparation of the financial statements, disclosure of reserves policy and in addition prepare supplementary fund/project statements for material funds/projects.
	• Requirement to report restricted funds separately from unrestricted funds as a minimum.
	• Requirement to use fund accounting for the income statement and for fund/reserve balances.
	• Requirement to disclose reserves policy.
	• Requirement to prepare supplementary fund/project statements for material funds/projects.
	• Additional NPO-specific guidance on extending fund accounting to other statements and additional funds/ reserves if relevant.
		Technical
		• Accounting for each fund separately may lead to improvements in financial management.
		Practical
		• Specific guidance to assist NPOs in their potentially complex arrangements and to address materiality and cost/benefit.
		Stakeholder
		• Presentation of restricted funds separately from unrestricted funds will increase transparency of available funds.
		  ◦ Improved consistency of presentation.
		  ◦ Greater transparency over material funds/projects.
		Cost/benefit
		• Presentation of supplementary fund/project statements may reduce the need for special purpose financial reports.
			Practical
			• May be difficult to agree a single format that will be granular enough to meet the needs of all large donors.
			• Additional records may be needed.
			Stakeholder
			• Increased length and complexity of the financial statements, and the presentation of different perspectives in the core statements and the supplementary statements, may be confusing for some stakeholders, making the financial statements less relevant.
			Cost/benefit
			• Cost of introducing fund accounting and supplementary statements may exceed the benefits.
			• The cost of preparing and auditing financial statements may increase.

Specific Matters for Comment 7

7.a Do you agree with the description of issue 7 Financial Statement Presentation? If not, why not?

7.b Do you agree that the list of alternative treatments that should be considered for issue 7 is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.

7.c Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 7? If you do not agree, please set out the changes you propose, and why these should be made.

7.d Please identify the alternative treatment that you favour for issue 7, and the reasons for your view. In your response please consider the presentation of unrestricted reserves allocated for internal purposes.

7.e The term statement of financial performance is used in the consultation paper to describe the statement that contains an NPO's revenues and expenses. Do you agree with the use of this term? If not, describe your preferred term and explain your reasoning.

Issue 8: Classification of expenses – function or nature?

1. Description of the issue

1.1 **To maintain trust, information about an NPO's expenses is particularly important.** NPOs may be expected to have higher levels of transparency than similar-sized private companies in order to be accountable to donors and maintain public trust. Stakeholders will need information about activities and to show how an NPO's objectives are being met (leading to continued financial support for that NPO, amongst other things). Expense information supports stewardship, transparency and accountability for an NPO's activities.

1.2 **Providing multiple analyses of expenses information creates a burden for NPOs.** NPOs may face a range of requirements for the categorisation of expenses depending on the jurisdiction in which they report and the demand from large funders. These requirements may come from a variety of sources, accounting standards/guidance, regulators, tax authorities and donors.

1.3 **Stakeholders may not all be interested in the same information**. Some users of the financial statements may be interested in the resources utilised for particular programmes or activities (ie analysis of expenses by function) while others may be more interested in the different types of expense required to deliver an activity, such as staff costs, materials, property costs etc. (ie an analysis of expenses by nature).

1.4 **Accounting requirements within individual jurisdictions may differ to the needs of resource provider and/or regulators**. Jurisdictions may already have accounting requirements that result in set parameters around how information must be presented. These requirements may either differ from or not address the needs of resource providers as well as regulators, which could lead to additional or multiple reporting requirements.

1.5 **Comparability between similar NPOs could be useful to the users of NPO financial statements**, particularly for donors, other funders and regulators, to assess the impact each organisation has achieved from resources given. An inconsistent approach will impact comparisons about the use of resources between organisations. However, there may be limitations to comparability due to other factors such as the business model and profile of incoming resources. Information could also be provided by appropriate narrative reporting.

1.6 **Users of the financial statements may have an interest in the significance of support costs in comparison to the total expenses of an NPO.** This may be particularly so for understanding those expenses that form part of

an NPO's overheads/running costs and those that are used to directly fund the delivery of an NPO's objectives. Support services including the finance function, IT, human resources, legal and governance are a necessary part of operating an NPO. Similarly, users may also be interested in distinguishing the expenses incurred in generating funds from those incurred in delivering programmes or activities to beneficiaries, and the relationship between their donation and the cause to which they donated.

1.7 **Donors, grantors and regulators can focus on and benefit from a functional analysis of expenses and the ratios which are developed from it**. Such an analysis can support both stewardship and accountability. Problems arise when this might not be sufficient to provide the level of detail needed to fully understand spend on individual programs.

2. Financial reporting challenges

2.1 **It may be challenging to determine the most appropriate disclosures for inclusion in a single set of Guidance for NPOs**. NPOs need to reflect their expenses in a way that provides a reliable and faithful representation but in a way that also takes account of the cost/benefit of alternative presentations. Broadly the two options for classifying costs are by function (the main areas of an NPO's activities) or by nature (staff costs, property costs, depreciation etc).

2.2 **Analysis of expenses by function may not aid comparability by stakeholders**. While enabling each NPO to take an approach that best enables it to report on its activities, a functional analysis is likely to vary considerably between NPOs because of differing business models, differing programmes and bundling of activities. If a functional presentation is adopted, an NPO could disclose key amounts by nature too.

2.3 **Allocating costs to functions may involve considerable judgement**. A functional analysis of expenses that supports the identification of activities can provide more relevant information to users and particularly donors than the classification of expenses by nature. In order to do this, NPOs need to allocate their overheads/running costs to their activities. Such judgements may not be transparent and therefore may erode donors' confidence in the information provided. Any lack of confidence in the expenses analysis may flow into their reading of complementary non-financial reporting including the calculation of ratios.

2.4 **Analysis of expenses by nature might be more useful to support reporting for regulatory purposes** or to identify accounting transactions such as depreciation. International standards recognise that a nature of expense analysis is more useful for predicting future cash flows. It may also be useful for NPOs in their decision making as it provides financial information about its inputs, over which it is likely to have control. As with a functional

analysis its usefulness will depend on the business model and has limitations as the analysis does not tell you what the inputs delivered.

2.5 **Analysis by nature and function may not be readily produced from an NPO's accounting system and result in additional costs**. Accounting systems that normally classify costs by nature, may lack the functionality to assign specific costs to both an account (for classification by nature) and an additional element to denote activity. If analysis of expenses is carried out by both nature and function, this will require financial systems to provide information which is detailed and multi-layered. Smaller and particularly the smallest NPOs may not have systems to be able to produce such information without significant additional costs.

3. Relevant international guidance

3.1 IFRS Standards, the *IFRS for SMEs* Standard and IPSAS all include specific provisions on the classification of expenses.

3.2 IAS 1 *Presentation of Financial Statements* and IPSAS 1 *Presentation of Financial Statements* require a similar classification to the *IFRS for SMEs* Standard. They require that an entity presents, either on the face of the statement of financial performance or in the notes, an analysis of expenses using a classification based on either the nature of expenses or their function within the entity, whichever provides information that is reliable and more relevant.

3.3 Both IAS 1 and IPSAS 1 specify that where an analysis by function is presented that the entity is also required to disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefits expense. IAS 1 and IPSAS 1 note that both forms are useful but because information on the nature of expenses is useful in predicting future cash flows, additional disclosure is required when the function of expense classification is used.

3.4 The *IFRS for SMEs* Standard requires that an entity analyses expenses using a classification based on either the nature of expenses or the function of expenses, whichever provides information that is reliable and more relevant:

- **Analysis of nature expense** – the *IFRS for SMEs* Standard provides examples of this classification of expense ie depreciation, purchases of materials, transport costs, employee benefits and advertising costs. It explains that these costs are not allocated across the functions of the entity.
- **Analysis by function of expense –** this classification requires expenses to be aggregated according to their function as part of cost of sales or, for example, the costs of distribution or administrative activities. In addition, other sections may require disclosure of certain costs by nature.

3.5 The standards are intended to provide users with information on performance, and the IPSAS particularly notes that the disclosures allows users to identify resources allocated to support the major activities of the entity and enhance transparency to enable an entity to discharge its accountability decisions.

3.6 The IASB has recently consulted (ED/2019/7) on amendments to IAS 1, which will require entities to present in the operating category of the statement of profit or loss an analysis of expenses using a classification based on either the nature of expense method or the function of expense method. Where the functional analysis of expenses is chosen, an analysis by nature is also proposed in the notes to the accounts. This goes further than the current options about where this information is best presented in the financial statements. The analysis provided will need to be the one which provides the most useful information. The Exposure Draft also prohibits entities from using a mixed approach to presenting the analysis of expenses on the Statement of Financial Performance.

4. National-level guidance[48]

4.1 There are differences both within and between jurisdictions that have NPO guidance as to how expenses are required to be analysed.

4.2 A number of jurisdictions have standards or guidance that are consistent with international accounting standards and allow entities to choose between classification based on either the function of expense or nature of expense methods.

4.3 However, there are jurisdictions that have taken alternative approaches, but are still reflective of the international guidance. For example, in one jurisdiction, separate provisions in the form of multiple Statements of Recommended Practice (the SORPs) specify the requirements for different types of NPOs. The SORPs direct the analysis of expenses to be used, with separate analyses for different types of NPO, to reflect their specific reporting needs.

4.4 In another jurisdiction NPOs are required to provide functional expenses grouped by program or support as well as a nature of expense categorisation (eg payroll, rent, etc). These can be made on the face of the statement of activities (statement of financial performance), in a disclosure, or in a separate financial statement. This approach was adopted to improve the understanding of an organisation's service efforts and to understand inputs, which most organisations were using to track expenses.

[48] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

4.5 One national model (under its simplified approach to accrual accounting for not for profit entities) includes a hybrid approach to the classification of expenses. It requires as a minimum, the following aggregated categories to be reported separately:

- expenses related to public fundraising
- volunteer and employee related costs
- costs related to providing goods or services, and
- grants and donations made.

These categories mix both the nature of expenses and the function of expense analyses. This model also allows disaggregation of the abovementioned categories or new categories to be added in the statement of financial performance, when such presentation will enhance users' understanding of the entity's financial performance. The guidance suggests a list of possible disaggregated or additional classes (these classes are based on a nature of expenses analysis).

5. Alternative reporting approaches

5.1 The choice between the function of expense method and the nature of expense method depends on historical, sectoral and regulatory factors and the nature of an NPO. Each method of presentation has benefits for different types of entities. Both methods provide an indication of those costs that might vary, directly or indirectly, with the level of activity of an NPO.

5.2 **Alternative 1** follows IFRS Standards, the *IFRS for SMEs* Standard and IPSAS, allowing each entity to decide how best to present its expenses based on either their nature or their function within an NPO, whichever provides information that is reliable and more relevant. If a functional analysis is chosen, then a nature of expenses analysis must also be disclosed. The presentation chosen must be used on the face of the Statement of Financial Performance.

5.3 **Alternative 2** would remove the choice of primary analysis and require either a by nature or functional analysis of expenses on the face of the Statement of Financial Performance. Whichever analysis is mandated, the other would be permitted to be included in the notes to the financial statements. This approach would limit the choice in international guidance.

5.4 **Alternative 3** would require both methods of analysis to be produced, but a choice as to which method is used for the primary statement. This alternative would form new international guidance as it departs from international accounting standards. While this approach would make consistent the requirements on NPOs, smaller NPOs may need exemptions.

5.5 **Alternative 4** proposes to combine elements of the nature and function analyses to produce a single analysis. This approach follows the approach used by a national guidance and could be appropriate for less complex entities. This single analysis would intend to meet the needs of all stakeholders.

5.6 The alternatives assume that whichever classification of expenses is used each class would be disaggregated into material classes of expenses that are useful to the users of the financial statements. It might be the case that Guidance issued would need to prescribe a minimum classification level. For example, a function of expense analysis might prescribe an analysis of major classes of programme services/activities and mandate the inclusion of expenses on fundraising. A nature of expense analysis could include the following:

- employee expenses/benefits
- transport expenses
- depreciation and amortisation expenses
- premises costs including lease and rental expense, and
- interest expense.

5.7 The Guidance will provide information on the allocation of support services including the method of allocation to support the use of a functional analysis of expenses. The Guidance could also set out the information needed about how programme/activity information has been aggregated, as it is not expected that each programme or activity is individually provided.

	Description	Advantages	Disadvantages
Alternative 1 Allow analysis by function or nature of expense.	• Require NPOs to present an analysis of expenses using a classification based on either the nature of expenses or the function of expenses whichever provides information that is reliable and more relevant. • Guidance could require that the analysis chose is presented on the face of the financial statements.	**Technical** • Consistent with IFRS Standards, the *IFRSs for SMEs* Standard and IPSAS. **Practicality** • Provides flexibility for NPOs to choose the more appropriate method and easy to implement. **Stakeholder information** • Allows the preparation of information about an NPO's overheads/running costs. • Allows NPOs to produce an analysis that is most useful to the users of their financial statements. • If the analysis is presented on the face of the financial statements, it may help users access and understand the information. **Cost/benefit** • The choice enables the most cost-effective basis.	**Stakeholder information** • Permitting choice does not enable comparability between NPOs to assess how well an NPO has utilised the resources donated and given to it. **Cost/benefit** • The most informative is not always the easiest analysis to produce.
Alternative 2 Require analysis of expenses by nature or require analysis of expenses by function.	• Require NPOs to provide only the analysis of expenses by nature on the face of the Statement of Financial Performance or alternatively only an analysis of expenses by function on the face of the Statement of Financial Performance. • Additional analysis could be provided but there is no choice over the primary analysis.	**Technical** • Type of analysis allowed by IFRS Standards, the *IFRSs for SMEs* Standard and IPSAS. **Practical** • If analysis of expenses this may be easier to produce, as most likely to match internal reporting requirements. **Stakeholder information** • If analysis of expenses by nature this will enable comparability with other NPOs and other organisations. **Cost/benefit** • Easier to produce than functional analysis.	**Technical** • May weaken international standards as removes the requirement for the most relevant presentation. **Practical** • Could be resource demanding for NPOs (particularly smaller NPOs). **Stakeholder information** • If nature of spend analysis it will not provide information on the cost of activities or an NPO's running costs, which may be more useful to users such as donors.

	Description	Advantages	Disadvantages
Alternative 3 Require analysis on both a function of expense and nature of expense analysis.	· ·Require classification based both on the nature of expenses and the function of expenses in the performance statement or in the notes to the accounts. The analysis which provides information that is reliable and more relevant should be included on the face of the performance statement with the alternative being included in the notes (to reduce excessive detail being included in the financial statements).	**Technical** · Types of analysis allowed by IFRS Standards, the *IFRSs for SMEs* Standard and IPSAS. **Stakeholder information** · Provides the benefits of both classifications and is more likely to meet the needs of most users. · Allows the preparation of information about an NPO's overheads/running costs. · Enable comparability with other NPOs and other organisations. · Possibility of functional comparisons.	**Technical** · Goes beyond the requirements of current international standards. **Stakeholder information** · Difficulty of determining and/or defining a common functional analysis to aid comparability. · Specification of functions risks the functional analysis not being useful for some groups of NPOs' and their users. **Cost/benefit** · The cost may outweigh the benefits particularly for smaller NPOs.
Alternative 4 Hybrid expense analysis, which sets out minimum reporting categories.	· Require classification to minimum, defined categories, which are to be reported separately on the face of the Statement of Financial Performance. · These categories mix both the nature of expenses and the function of expense analyses and could include expenses related to public fundraising, volunteer and employee related costs.	**Practical** · Only one analysis required which would simplify reporting. · Stakeholder information · Might meet the needs of stakeholder for less complex entities. **Cost/benefit** · Analysis could reduce additional reporting if it can be reflected in finance systems.	**Technical** · Not allowed by IFRS Standards, the *IFRS for SMEs* Standard or IPSAS. **Stakeholder information** · Difficulty in defining internationally applicable expense categories to meet the needs of all stakeholders.

Specific Matters for Comment 8

8.a Do you agree with the description of issue 8: Classification of expenses? If not, why not?

8.b Do you agree that the list of alternative approaches that should be considered for issue 8 is complete? If not, please describe your additional proposed alternatives, and explain why they should be considered.

8.c Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 8? If you do not agree, please set out the changes you propose, and why these should be made.

8.d Please identify the alternative approach that you favour for issue 8, and the reasons for your view. When considering your preferred approach please comment on which alternative:

- **i.** provides the best information about the key components of expenses or drivers of performance/activities?
- **ii.** most closely matches how management reports internally and the way the operation is run (to assist with the cost/benefit assessment)
- **iii.** whether the alternatives link to any key ratios that might be given in the narrative reporting (and therefore should be something that can be disclosed and reconciled to)
- **iv.** whether the alternatives permit accountability.

8.e Do you think that the alternatives for issue 8 provide the right balance between information presented on the face of the performance statements or in the notes?

8.f Would the allocation of expenses to functions outlined in issue 8 be so arbitrary that it would not provide a sufficiently faithful representation of the composition of an entity's functions?

8.g Are there any practical questions that arise in implementing your preferred option for issue 8?

Issue 9: Fundraising costs

1. Description of the issue

1.1 **Information about fundraising costs is important** to many users of NPO financial statements. Users may compare fundraising costs with the income generated, or with programme delivery costs, and use this information to assess efficiency. Ratios of fundraising costs to income or other costs may, however, be misleading.

1.2 **Fundraising activities and therefore costs are not easy to define.** Some fundraising activities may seem relatively obvious, such as a fundraising event or a shop to sell donated items. But many other activities are also important to income generation, such as business development (eg writing grant proposals), general brand awareness (eg having a website), but they may be less easily identified as fundraising.

1.3 **Activities with the primary objective of raising funds may serve additional purposes.** For example, a fundraising event or printed brochure may also be used to share a mission-related awareness message, recruit volunteers, or identify potential service recipients. In this instance, a fundraising activity that fails to generate net income may still be considered worthwhile if the other objectives are met.

1.4 **The way direct costs are allocated to 'fundraising' can be subjective.** Fundraising activities may involve the effort of multiple staff to varying degrees, or the use of organisation assets. The method used to allocate direct costs (such as staff time, running costs for a shared vehicle, or depreciation) to different projects or activities can vary widely from one organisation to the next. This may lead to a lack of comparability amongst similar NPOs.

1.5 **The true cost of fundraising activities may include an element of indirect costs**. The methods used to allocate indirect costs to activities can vary widely between organisations. NPOs may have incentives to maximise the amount of overheads allocated to service delivery activities compared to management or fundraising.

1.6 **The costs and complexities of allocating indirect costs may outweigh the benefits.** It may be difficult to allocate overheads shared between fundraising activities and other activities. Although there are benefits in seeing the full cost of fundraising activities, the costs of doing so and practical difficulties may render this not worthwhile.

1.7 **Fundraising costs are generally incurred before the corresponding income is generated.** This timing difference means that the costs and income recognised in any given accounting period may not be comparable.

2. Financial reporting challenges

2.1 **The identification of costs of fundraising activities may not align completely with cost classification by function**, which is a method permitted in international standards. Fundraising costs may not comfortably belong to functional classification categories (production, administration, finance, selling, distribution, research and development) or natural classification categories (labour, materials and expenses). This may differ depending on the nature and size of the entity. For more information on classification of expenses see issue paper 8.

2.2 **Fundraising costs may not be readily identified from an NPO's accounting system.** The costs associated with fundraising activities may be found across various accounts within accounting systems that classify costs by nature, such as salaries, medical costs, internet, website, printing, travel, professional fees, depreciation etc. Accounting systems may lack the functionality for assigning specific costs to both an account (for classification by nature) and an additional element to denote activity.

2.3 **There may be benefits in standardising the definition of fundraising costs.** The most significant consideration would be how to define the fundraising costs in a way that can be applied across NPOs. The Guidance could address the presentation of direct fundraising costs, the treatment of business development costs, the basis of allocation of overheads and disclosure requirements.

2.4 **Fundraising costs should be recognised using the same principles as any other expenditure,** ie at the point the good or service is received. This may lead to timing differences between fundraising costs being incurred and the recognition of the resulting income.

2.5 **Fundraising costs should be presented gross**, in accordance with the 'no netting off' principle adopted in international accounting standards, consistent with all other expenditure. However, in some instances this may not be practical.

2.6 **Additional disclosures could be considered to assist users** understand fundraising activities, with standardised information about fundraising costs and information about timing differences. Such detailed requirements would go beyond the general presentation and disclosure requirements of current accounting standards. These disclosures could form part of the notes to the accounts or be a part of narrative reporting. Narrative reporting in most jurisdictions has lower levels of audit scrutiny.

2.7 **The usefulness of ratios could be considered further** if a framework is developed for narrative reporting (see issue paper 10 for more information on narrative reporting).

3. Current international guidance

3.1 Neither IFRS Standards, nor the *IFRS for SMEs* Standard nor IPSAS specifically address this issue.

Presentation of expenses by nature or function

3.2 IAS 1 *Presentation of Financial Statements* and IPSAS 1 *Presentation of Financial Statements* require an entity to present an analysis of expenses classified either by nature or function within the entity, whichever provides information that is reliable and more relevant. This information may be presented either on the face of the statement of financial performance or in the notes. Function is not defined in either standard.

3.3 The *IFRS for SMEs* Standard requires an entity to present an analysis of expenses classified either by nature or function:

- Analysis by nature of expense – examples are provided eg depreciation, purchases of materials, transport costs, employee benefits and advertising costs. It explains that these costs are not allocated across the functions of the entity.
- Analysis by function of expense – this categorisation requires expenses to be aggregated according to their function as part of cost of sales or, for example, the costs of distribution or administrative activities.

Segmental reporting

3.4 Fundraising could be a segment as defined by international accounting standards but using a segment for fundraising would require other parts of the business to be reported in the same way and require the disclosures on performance, assets and liabilities.

3.5 Both IFRS 8 *Operating Segments* and IPSAS 18 *Segment Reporting* focus on the disclosure of operating segments of an entity and on the services and geographical areas in which an entity operates. The standards are intended to provide users with more information on performance and assets and liabilities.

3.6 IPSAS 18 particularly notes that the disclosures allow users to identify resources allocated to support the major activities of the entity and enhance transparency to enable an entity to discharge its accountability decisions.

3.7 IFRS 8 requires a focus on the revenues of an entity and identification of segments is based on internal reports that are regularly reviewed by the entity's chief operating decision maker. The IPSAS is similar but the decision-making requirements for segmental information are more focussed on activities (as opposed to revenues) and therefore may provide a more useful reporting structure for NPOs.

3.8 There is no requirement for segment reporting in the *IFRS for SMEs* Standard.

4. National-level guidance[49]

4.1 While there is no specific international guidance a few jurisdictions have additional guidance on the reporting of fundraising costs. This national guidance does not provide a single view of the definition of the cost of fundraising.

4.2 One jurisdiction requires all expenditure on fundraising to be identified and provides a list of activities as examples. These examples for registered charities in the jurisdiction include; seeking grants and donations, operating membership schemes and social lotteries, staging events (including the performance fees, licence fees and other related costs), contracting with agents to raise funds on behalf of the charity, operating charity shops selling donated and/or bought-in goods, operating a trading company undertaking non-charitable trading activities, advertising, marketing, and direct mail materials. It also requires that costs and income are shown gross.

4.3 One jurisdiction has guidance for smaller entities that provides for an analysis of expenses that draws on expenses by nature and function. Expenses for public fundraising are required to be disclosed as part of this guidance.

4.4 Another jurisdiction provides guidance on allocating costs to fundraising from certain joint activities. Typically, advertising and other business development costs are not included in Fundraising Costs but would be included in other functional activities such as 'Management and General Activities'. It requires the cost of fundraising to be presented on a gross basis except for some costs associated with special events such as fundraising galas. The guidance includes what it describes as a programmatic element.

4.5 Another jurisdiction has guidance that addresses the timing of the recognition of fundraising costs.

[49] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

5. Alternative financial reporting treatments

5.1 IFRS Standards, the *IFRS for SMEs* Standard and IPSAS all allow expenses to be analysed by nature or function in the financial statements.[50] They all require expenses to be presented on a gross basis.

5.2 **Alternative 1** allows organisations to use any of the international frameworks as they have similar requirements. This would allow NPOs to continue to develop their own policies on the treatment of such costs, with additional guidance to support NPOs with the identification of fundraising costs and could provide recommendations for financial reporting. This might include fundraising costs being reported as a function as part of a functional analysis.

5.3 **Alternative 2** requires an entity to follow IFRS Standards, the *IFRS for SMEs* Standard or IPSAS with additional guidance that requires (where fundraising costs are included in the financial statements), an NPO to disclose its accounting policy for fundraising costs. This would include which types of costs form part of this activity and the approach to allocation of overhead.

5.4 **Alternative 3** would rely on new NPO-specific guidance being developed. This would require fundraising costs to be disclosed along with the accounting policy. The Guidance developed for this alternative could provide the basis for a standard definition along with cost allocation methodologies, and might usefully include a list of fundraising activities to assist NPOs, such as:

- Direct staff costs for the fundraising activity.
- Materials required for the fundraising activity including for example, printing and mailing costs, performance fees, licence fees and other related costs.
- IT costs.
- Agency fees and costs.
- Marketing and advertising costs.
- Planning and research costs.
- Costs of any outsourcing work or consultancy.
- Allocation of indirect costs including general overheads, business development and administration.

5.5 IFRS Standards and IPSAS include segmental reporting requirements in their analysis of expenses. Segmental reporting has not been included in the alternatives as it may be too onerous for smaller organisations.

5.6 Consistent with the international frameworks, none of the alternative approaches permit costs to be netted from the related income. Pragmatically, there may be a limited number of examples where exemptions from this might be permitted.

[50] The Exposure Draft of the IASB's Primary Financial Statement's project introduced a new 'financial activities' category with the income statement, which might be relevant to this too.

	Description	Advantages	Disadvantages
Alternative 1 Follow existing international guidance on the recognition, presentation and disclosure of expenses with NPOs deciding whether the resulting information is reliable and relevant to its users of the financial statements. Additional guidance will support NPOs.	• Expense recognition, measurement and presentation to follow relevant international standards. • Fundraising expenses to be presented (and disclosed) in accordance with an NPO's decisions on whether this information is reliable and relevant to the users of the financial statements. • The costs must not be netted off from income received from fundraising. • Additional guidance to provide NPO-specific examples and could recommend reporting to stakeholders.	**Technical** • Follow IFRS Standards, the *IFRS for SMEs* Standard and IPSAS. **Practical** • Easy to implement. **Cost/benefit** • Cost neutral.	**Stakeholder information** • This could lead to inconsistent approaches across similar NPOs. • This may mean that stakeholders are not able to assess an NPO's performance in relation to the cost of fundraising.
Alternative 2 Follow existing international guidance on the recognition, presentation and disclosure of expenses with NPOs deciding whether the resulting information is reliable and relevant to its users. Require the disclosure of the accounting policy on fundraising costs only if such costs are disclosed in the financial statements. Additional guidance will support NPOs.	• Expense recognition, measurement and presentation to follow relevant international standards. • Fundraising expenses to be presented (and disclosed) in accordance with an NPO's decisions on whether this information is reliable and relevant to the users of the financial statements. • The costs must not be netted off from income received for fundraising. Require disclosure of the accounting policy on fundraising costs only if reported separately in the financial statements, ie under either an analysis by function of expense or as a part of a segmental analysis. • Additional guidance to provide NPO-specific examples and could recommend reporting to stakeholders.	**Technical** • Allowed by IFRS Standards, the *IFRS for SMEs* Standard and IPSAS. **Practical** • Easy to implement. **Stakeholder information** • Increased transparency could provide users with a clearer understanding of the costs of fundraising. • Improved understanding of the costs to raise a unit of funding.	**Stakeholder information** • This could lead to inconsistent approaches across similar NPOs. **Cost/benefit** • May result in additional disclosures to prepare and be subject to audit. • Might create a disincentive to disclose costs of fundraising if additional disclosures are required.

	Description	Advantages	Disadvantages

Alternative 3
Develop new NPO-specific guidance that requires disclosure of the amount and accounting policy for fundraising costs.
	• Expense recognition, measurement and presentation to follow relevant international standards.
	• Require reporting of fundraising costs, using pragmatic guidance on the presentation and disclosure of expenses which requires NPOs to:
	  • report its accounting policy for the cost of fundraising
	  • disclose fundraising costs in a note to the accounts.
	• The costs must not be netted off from income received for fundraising.
		Technical
		• Allowed by IFRS Standards, the *IFRS for SMEs* Standard and IPSAS.
		Practical
		• Flexibility to define the costs of fundraising within the principles established by the guidance.
		Stakeholder information
		• Supports a more consistent approach to define the costs of fundraising.
		• Increased transparency enables users to have a clearer understanding of the costs of fundraising.
		• Improved understanding of the costs to raise a unit of funding
			Stakeholder information
			• Not able to report the costs of fundraising in a way which is most relevant to the organisation.
			Cost/benefit
			• May result in additional disclosures to prepare and be subject to audit.

Specific Matters for Comment 9

9.a Do you agree with the description of issue 9 – Fundraising costs? If not, why not?

9.b Do you agree that the list of alternative approaches that should be considered for issue 9 is complete? If not, please describe your additional proposed alternatives, and explain why they should be considered.

9.c Do you agree with the advantages and disadvantages articulated for each alternative accounting approach for issue 9? If you do not agree, please set out the changes you propose, and why these should be made.

9.d Please identify the alternative approach that you favour for issue 9, and the reasons for your view.

9.e Do you agree that all fundraising costs should be presented gross? If not, please provide example of where this might not apply and the reasons for your view.

Issue 10: Narrative reporting

1. Description of the issue

1.1 **Financial statements do not tell the whole story.** There has for decades been a recognition that financial statements, while being important, do not meet all the information needs of users and that there is a need for the provision of other information giving details of, for example, an entity's performance and prospects. For example, in 1978 the European Union introduced a requirement that the reporting package of financial information consists of financial statements and the annual report, and that the latter "...must include at least a fair review of the development of the company's business and of its position".

1.2 **The importance of such other, narrative, information is as relevant, if not more so, for NPOs, in particular for demonstrating accountability and stewardship to stakeholders and civil society**. For many NPOs, the financial statements may not capture some of the most important aspects of an organisation's performance, which can focus more on non-financial issues and measures. Examples of such aspects could include the use and importance of volunteer contributions and the impact of an organisation on the communities and beneficiaries it seeks to serve.

1.3 **Non-financial reporting can bring greater clarity**. For NPOs there can be a lack of clarity on the reporting of remuneration, governance arrangements and the effectiveness of an NPO with a focus on making maximum use of resources received. As noted in issue paper 9 on Fundraising Costs, this can be addressed through the publication of ratios that are intended to demonstrate the relationship between fundraising and service delivery costs.

1.4 **Disclosure requirements currently vary across jurisdictions, dependent on local accounting requirements, local regulation and local legislation**. This can make it challenging for stakeholders where an NPO's General Purpose Financial Reports (GPFRs) are used in multiple jurisdictions or where a stakeholder is using GPFRs from similar NPOs that operate in different jurisdictions.

2. Financial reporting challenges

2.1 **Which framework to use?** Non-financial reporting has become a 'growth industry' in recent years, with the proliferation of multiple frameworks, codes, standards and guidelines on a wide range of reporting issues, many in the broad area of sustainability (also referred to as corporate responsibility, corporate social responsibility (CSR), and environmental, social and governance (ESG) reporting). There is also an increasing focus on reporting on climate-

related issues. An initial challenge would be to determine which of the multiple frameworks, codes, standards and guidelines would be the most appropriate basis on which to develop proposals for narrative reporting by NPOs.

2.2 **At which level should non-financial reporting proposals be pitched?** There is also an issue as to the extent to which any proposals for non-financial reporting by NPOs should be pitched at a 'framework' level, articulating broad principles and content elements to be included, rather than any other more specific items and/or measures to be included. For example, the issues of the classification of expenses by function or nature and fundraising costs (Issues Papers 8 and 9 respectively) and, in particular, whether disclosures relating to such costs and their categorisation (including ratio analysis of such costs) could form part of the notes to the financial statements or part of non-financial reporting. It should be noted that disclosures as part of the financial statements are subject to audit, rather than more limited assurance review for the material that accompanies the financial statements.

2.3 **There is a challenge in providing information from a management perspective.** Narrative reporting is usually prepared from the perspective of the management of an organisation, hence its description using terms such as "management commentary" (see paragraph 3.1). Narrative reporting provides an opportunity for management to provide to stakeholders its perspective of the organisation's performance, position and progress, including information that is useful to an understanding of:

a. the nature of the organisation's business
b. management's objectives and its strategies for meeting those objectives
c. the organisation's most significant resources, risks and relationships
d. the results of operations and prospects (including information that both complements and supplements the financial statements, as well as providing forward-looking information)
e. the key performance measures and indicators that management uses to evaluate the organisation's performance against stated objectives.

2.4 **How much flexibility is allowed?** The general principles and content elements of narrative reporting could be applicable to all organisations, although the appropriate level of detail in reporting could differ depending on factors such as an organisation's size, complexity and resources. The flexibility of a principles-based approach is relevant to consider in the context of the calls that have been made for NPO narrative reporting to address such matters as the remuneration of key management personnel and related party disclosures.

2.5 **There may be a challenge in exercising judgement.** A framework approach based on principles demands more judgement from management than a more prescriptive approach and there can be a risk that, faced with interpretative

uncertainty, management will err on the side of caution and disclose larger quantities of data rather than exercising the judgement required to present the information to meet stakeholders' needs. This may generate confusion, rather than transparency if reports become overly complex. Also, requirements in local jurisdictions could add to or be inconsistent with disclosures arising from a framework type approach.

2.6 **Some aspects of narrative reporting can involve more uncertainty than the information presented in the financial statements**. This is the case, for example, in the provision of forward-looking information, where it could be appropriate for management to explain any material assumptions in the preparation and disclosure of such information. There will also be challenges in the inclusion of non-financial measures and indicators, where management will have to explain how these measures and indicators are defined and calculated. There will also be a challenge in management reporting in a balanced way, dealing even-handedly with both good and bad aspects of the performance, progress and prospects of the organisation.

2.7 **Non-financial information can be challenging to audit.** Much of the narrative reporting that currently takes place at both international and national level is within an organisation's annual report, but outside the financial statements. As a consequence, such reporting falls outside the scope of a formal opinion by the auditors on the financial statements, although there will often be a requirement on the auditors (for example, as in International Standard on Auditing (ISA) 720 (Revised) *The Auditor's Responsibility Relating to Other Information*) to read such information to identify any material inconsistencies between that other information and (a) the financial statements and (b) the auditors' knowledge obtained in the audit. This is a level of assurance significantly less than that of a formal audit.

3. Current international guidance

3.1 IFRS Standards do not address the issue of narrative reporting within the Standards themselves, but the IASB in 2010 issued a non-mandatory Practice Statement *Management Commentary*, which does cover the issue. The IASB is in the process of reviewing and revising the Practice Statement, with an Exposure Draft (ED) scheduled for release during the first half of 2021.

3.2 The *IFRS for SMEs* Standard does not specifically include narrative reporting, although the non-mandatory practice statement is available for use.

3.3 Likewise, IPSAS do not specifically address this issue within the Standards themselves. The IPSASB has also issued non-mandatory material in the form of Recommended Practice Guidelines (RPGs) to address the issue, as follows:

- RPG 2 *Financial Statement Discussion and Analysis* (2013), which covers some, but not all, the issues covered in the IASB's Practice Statement referred to above, focusing on an explanation of the significant items, transactions and events presented in an entity's financial statements and the factors that influenced them; and
- RPG 3 *Reporting Service Performance Information* (2015), which focuses more on how an entity should report on its effectiveness, efficiency, inputs, outputs and outcomes, together with its performance indicators and service performance objectives.

3.4 Both the IFRS Practice Statement and IPSAS RPGs adopt a framework approach based on principles, giving entities flexibility on how to apply them relevant to their own circumstances, rather than setting out very specific individual recommendations.

3.5 Both the IASB and IPSASB have standards on related party disclosures (IAS 24 *Related Party Disclosures* and IPSAS 20 *Related Party Disclosures*) which focus on the disclosure in the notes to the financial statements of remuneration (including salaries and other benefits such as pensions) of key management personnel (in aggregate) and related party disclosures. The *IFRS for SMEs* Standard requires related party disclosures consistent with IAS 24.

3.6 Outside of the IASB and IPSASB guidance, one other major relevant development (of many, as noted above) in recent years has been the growth of Integrated Reporting (IR), in particular the International Integrated Reporting Framework developed by the International Integrated Reporting Council (IIRC).

3.7 The IIRC Framework provides a non-mandatory, principles-based reference for organisations wishing to adopt Integrated Reporting. The primary purpose of an integrated report is to explain to providers of financial capital (and other stakeholders) how an organisation creates value over time. An integrated report aims to provide insight about the resources and relationships used and affected by an organisation (referred to as capitals in the Framework, covering financial, manufactured, intellectual, human, social relationship, and natural capital). The Framework approach enables an organisation to set out its report in its own way rather than adopt a checklist approach. In February 2020, the IIRC launched a process to revise the Framework.

3.8 While developed for the for-profit sector, IR could be relevant for NPOs to demonstrate how they seek to optimize their use of available resources and report on operations to their stakeholders.

4. National-level guidance[51]

4.1 There are differences between jurisdictions in the requirements and/or guidance for narrative reporting by NPOs. We are unaware of any jurisdiction that has a separate standard or standards governing narrative reporting by NPOs.

4.2 One jurisdiction provides guidance on narrative reporting within its overall requirements for accounting and reporting by NPOs. In that jurisdiction, a Statement of Recommended Practice (SORP) sets out not only requirements for the preparation of financial statements, but also the content of the annual report prepared by the management body (the trustees in this instance), including the context for, and a narrative explanation of, the financial information contained in the accounts. There are differential narrative reporting requirements, given the greater degree of accountability to civil society and stewardship reporting required of larger NPOs. Those requirements share much in common with the jurisdictional requirements for narrative reporting by corporate entities, which in turn share much in common with the IASB's *Management Commentary* Practice Statement.

4.3 Another jurisdiction has a specific standard that sets out requirements for its Public Benefit Entities (NPOs) in their reporting of service performance information. The standard takes into account the extent to which the recommendations in IPSASB's RPG 3 are appropriate in the jurisdictional context. As with the jurisdiction referred to in paragraph 4.2 above, the standard contains differential reporting requirements. The standard also establishes principles and high-level requirements for the reporting of service performance information rather than specifying detailed reporting requirements.

4.4 A number of other jurisdictions, whilst having no general guidance covering narrative reporting by NPOs as part of their annual reports, do have specific requirements to lodge annual information with their relevant regulatory body. However, such annual returns are generally focused on meeting the information needs of a regulatory body, rather than forming part of General Purpose Financial Reporting (GPFR).

5. Alternative financial reporting treatments

5.1 Given the importance of narrative reporting in the NPO context, and the fact that there is existing guidance at both international and jurisdictional level, it could be beneficial to incorporate the development of global narrative reporting guidance as part of the IFR4NPO initiative.

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[51] Additional information on national guidance of a limited number of jurisdictions can be found in Supplementary Information: International and national financial reporting standards and guidance.

5.2 **Alternative 1** proposes the continued use of existing guidance relevant in each jurisdiction, would be the default option if feedback from respondents proposes that narrative reporting is not included within the scope of the project. The scope of this project, which is proposed to include narrative and non-financial reporting, is considered in Part 1 to this document. This would mean that individual jurisdictions and/or organizations would continue to develop their own policies and guidance on narrative reporting.

5.3 **Alternative 2** proposes additional guidance for NPOs consistent with the recommendations of the IASB and IPSASB, but with specific NPO examples consistent with Part 1. In this alternative, applying the principles outlined in the additional guidance could be required for all GPFRs.

5.4 **Alternative 3** proposes to move ahead of current international accounting guidance and move to the International Integrated Reporting Council framework. This could be tailored for NPOs and enable a comprehensive view of an organisation's resources and relationships and how it has used these and plans to use them over time. In tailoring for NPOs, this would focus on the needs of NPO stakeholder groups. This alternative, with its tailored solution arguably goes beyond the proposed way forward in Part 1: Chapter 5. Given the flexibility inherent in the *IIRC Framework* and its standing as an international framework, the case can be made that it is consistent with harnessing international guidance as set out in the proposed way forward.

	Description	Advantages	Disadvantages
Alternative 1 'Do nothing' Leave organisations/ jurisdictions to follow existing guidance on narrative reporting by NPOs.	• Organisations are left to follow any existing guidance or requirements in their own jurisdictions, or to voluntarily apply any existing international guidance.	**Technical** • Meets the requirements/ recommended practice of IFRS and IPSAS. **Practical** • No change on the current position so easy to implement. **Cost/benefit** • Minimises burdens on NPOs.	**Practical** • Missed opportunity to develop global best practice on what 'good' narrative reporting should cover. **Stakeholder** • Many jurisdictions have no guidance at all on non-financial reporting, which would remain the case. • Inconsistent approaches across similar entities and across jurisdictions. • Fails to reflect the importance of, narrative reporting across all sectors and across the world and the transparency that results.
Alternative 2 Apply existing international guidance on narrative reporting, tailored as appropriate for reporting in the NPO context.	• Narrative reporting is required to accompany the financial statements based on additional guidance drawing on international guidance on narrative reporting.	**Technical** • Meets the requirements/ recommended practice of IFRS and IPSAS. **Practical** • Clear framework providing principles for the basis of narrative reporting. **Stakeholder** • Better communication with all stakeholders, with improved and fuller understanding by all stakeholders of the performance, position and prospects of NPOs.	**Practical** • NPOs may have to apply greater judgement in difficult areas, such as forward-looking information and non-financial measures and indicators. **Cost/benefit** • Will result in additional narrative disclosures to prepare.

	Description	Advantages	Disadvantages
Alternative 3 Apply integrated reporting, following the IIRC Framework, tailored as appropriate for reporting in the NPO context.	• NPOs to produce an integrated report in line with the IIRC Framework, providing insight of each of the six capitals. • Would incorporate alternative 2 but go beyond it in the provision of a wider integrated report. • Additional guidance to assist NPOs in applying the framework.	**Technical** • Meets the requirements/ recommended practice of IFRS and IPSAS. • Could put NPOs at the forefront of corporate reporting. **Practical** • IIRC Framework provides a great deal of flexibility in how organizations report, allowing them to develop their reporting over time. • Clear framework providing principles for the basis of narrative reporting. • Provides an opportunity to address/change internal management processes to achieve integrated management. **Stakeholder** • Better communication with all stakeholders, with improved and fuller understanding by all stakeholders of the performance, position and prospects of NPOs.	**Practical** • Will involve NPOs in having to apply greater judgement in determining narrative reporting disclosures in difficult areas, such as forward-looking information and non-financial measures and indicators. • Need to address/change internal management processes (which could also be an advantage). **Cost/benefit** • Could place administrative burdens on NPOs to understand and report on issues/ areas that go beyond GPFR. • Uncertainties about the cost of preparation of an integrated report.

Specific Matters for Comment 10

10.a Do you agree with the description of issue 10 – Narrative reporting? If not, why not?

10.b Do you agree that the list of alternative treatments that should be considered for issue 10 is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.

10.c Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 10? If you do not agree, please set out the changes you propose, and why these should be made.

10.d Please identify the alternative treatment that you favour for issue 10, and the reasons for your view.

10.e Should narrative reporting guidance be set at the level of a framework and principles, rather than any more specific reporting requirements or recommendations? If you disagree, what additional guidance on what specific reporting requirements or recommendations would be beneficial?