Practitioner Advisory Group Issue Paper

AGENDA ITEM: PAGED05 - 02
16 March 2022 – Online

Presentation of Financial Statements

Summary	The paper sets out proposals for developing the Guidance on the presentation of financial statements.
Purpose/Objective of the paper	This paper describes the proposed approach to addressing a number of issues in the Guidance on the presentation of financial statements. The objective of this paper is to seek feedback on the extent to which these proposals are practical and will meet user needs.
Other supporting items	None
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Actions for this meeting	Provide advice on: • The name to be used for the statement of financial performance. • The practicalities of separate presentation of restricted/unrestricted funds • The advantages of an approach that allows deferral of revenue. • Proposals for an optional donor/project statement.

Practitioner Advisory Group

Presentation of Financial Statements

1. Background

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

1.2 The Consultation Paper covered a range of topics related to financial statement presentation and the responses to the Consultation Paper have raised several issues that need to be addressed. This paper seeks input from the PAG on the proposals for developing the Guidance in a number of specific areas.

2. Proposals

Statement of financial performance

2.1 The Consultation Paper proposed the use of the term 'statement of financial performance' for the statement that contains the NPO's income and expenses. Of the responses that discussed this issue, just under two thirds supported the use of this term.

2.2 The main reason given by those who did not support the use of the term was that NPOs' performance is not judged on whether they make surpluses or deficits, but whether they meet their aims and objectives (social performance). Using the term 'financial performance' could imply that this is the main measure of NPOs' performance, which is not the case.

2.3 Respondents also noted that 'financial performance' might be misleading. For NPOs, income and expenses may not align in the same way as a commercial organisation, and hence the surplus or deficit reported in a financial year does not necessarily reflect the performance of the NPO.

2.4 The most commonly suggested alternative terms were 'statement of income and expenses' and 'statement of financial activities' as these terms were considered to be better understood by NPOs' stakeholders.

2.5 There are advantages in using the term 'statement of income and expenses' as this term is most likely to be understood by the general public. There are also advantages to retaining the term 'statement of financial performance' as this term is also used in the commercial and public sectors.

2.6 The ‘statement of financial activities’ is a requirement of the UK Charities SORP. Using the same term with potentially different requirements may cause confusion for those that have guidance based on this source.

Question 1: What are the PAG’s views on the name to be used for the statement of financial performance?

Subsequent considerations

2.7 Whilst not specifically covered in the Consultation Paper consideration is now being given to how the financial statements might look. The following paragraphs set out initial thinking which is being used to frame the work of the Secretariat.

Format of financial statements

2.8 The *IFRS for SMEs* Standard specifies the minimum items to be included in each financial statement but does not specify a format. This allows flexibility in presenting the financial statements. For example, a statement of financial position could have a vertical or horizontal presentation, and a statement of financial performance could present expenses before income.

2.9 The INPAG Secretariat believes that this flexibility could be helpful as different jurisdictions have different regulations and practices and currently expects to retain this flexibility in the Guidance.

Surplus and Deficit

2.10 The INPAG Secretariat considers that the equivalent of profit or loss in the commercial sector is surplus or deficit for NPOs.

2.11 Current thinking is that in defining surplus or deficit, this would include recognised gains and losses, for example the gain on the sale of an asset. Surplus or deficit would exclude unrecognised gains and losses, for example the gains and losses that arise from revaluations of items such as land and buildings and defined benefit pension liabilities.

2.12 The INPAG Secretariat is currently of the view that the statement of financial performance would end with the surplus or deficit. This is consistent with the ‘two statement’ approach in the *IFRS for SMEs* Standard.

2.13 PAG members have been asked for thoughts on the key numbers/information for the users of financial statements. This feedback will be helpful in the further work of the Secretariat as work is taken forward to develop proposals for financial statement presentation. As decisions on technical accounting issues are made, and this will be through the whole of the development phase, these approaches may be modified and further input sought from the PAG.

Restricted and Unrestricted Funds

2.14 The Consultation Paper proposed three alternative financial reporting treatments for developing guidance for the presentation of NPO financial statements. Two of these alternatives required the use of fund accounting:

- Alternative 2 required, as a minimum, income to be split between restricted and unrestricted income in the statement of financial performance.
- Alternative 3 required supplementary donor or project statements for material funds or projects. These 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.

2.15 Fund accounting distinguishes between restricted and unrestricted funds, with income and expenses reported separately for each. Unrestricted funds can be used by NPOs for any purpose, whereas restricted funds can only be used for a specific purpose, usually because of a restriction placed by a donor. An illustration of how fund accounting could affect the presentation statement of financial position is shown in Appendix A to this paper. An actual example can be seen in the Annual Report of the RSPB.

2.16 Fund accounting can be conflated with project accounting but the two are different. A project may receive funding from restricted and unrestricted sources. In reporting on the project itself, all the funding irrespective of whether it comes from a restricted or unrestricted source would be included. With fund accounting the restricted element would be included within the restricted fund and unrestricted funds would be reported separately.

2.17 Fund accounting is also different to a deferred revenue model (see later), which is another mechanism that can be used to separate out funds being used for specific purposes.

2.18 Some responses to the Consultation Paper suggested that fund accounting is essential to ensure the stewardship of restricted funds and provide clarity regarding the NPO's free reserves position at year-end. Other responses suggested that fund accounting often results in more complex financial statements that readers find difficult to understand, and that it may not be suitable for all NPOs.

2.19 Overall, over two-thirds of responses that commented on this issue supported the use of fund accounting, although they did not indicate a strong preference for either Alternative 2 or Alternative 3.

2.20 The INPAG Secretariat acknowledges that adopting fund accounting could result in more complex financial statements, but considers this risk is outweighed by the need to provide information that supports the proper stewardship of restricted funds. This information is also needed for a full understanding of NPOs' financial statements.

2.21 The approach being considered by the INPAG Secretariat is to require an aggregation of restricted income and reserves and another aggregation of unrestricted income and reserves to be presented, consistent with the example in Annex A.

2.22 NPOs that wish to adopt full fund accounting by splitting restricted funds into individual funds or sub-aggregations would be permitted to do so.

Question 2: Does the PAG consider that the proposed restricted/unrestricted funds approach is practical and useful for users?

Deferred revenue model

2.23 Under a deferred revenue model, revenue is recognised in the same period in which the related expenses are incurred, allowing greater matching of revenue and expenses. This is the case regardless of whether donors impose restrictions on the use of the funds.

2.24 Because there is no link to restrictions on the use of funds, deferrals do not satisfy the definition of a liability. Deferrals are therefore not consistent with the concepts and principles that underpin international frameworks.

2.25 The deferred revenue model is not recommended because of these conceptual concerns and because it can be subjective or open to manipulation. However, it has the advantage in being easier for users of the financial statements to understand.

2.26 The IFR4NPO Consultation Paper on the topic on non-exchange revenue had an alternative that included a deferred revenue model for recognising non-exchange revenue. This alternative received only limited support (12% of those responses that addressed this issue).

2.27 The Consultation Paper also included alternatives where revenue is recognised when any restrictions attached to the use of the funds have been met; and recognised immediately where there are no restrictions as to its use. These alternatives are consistent with the concepts and principles, which is supported by the INPAG Secretariat.

2.28 The use of a deferred revenue model in INPAG would affect the design of the financial statements and advice from the PAG will help develop thinking around next steps on financial statement presentation.

Question 3:	What advice does the TAG have on the advantages and disadvantages of matching revenue to expenses, even when there are no restrictions? What useful information results for users?

Optional Donor/Project Statement

2.29 The need to satisfy donors' financial reporting requirements was seen by some respondents as a key factor in supporting the use of supplementary donor or project statements. NPOs were seen as having specific stakeholders, requiring specialised financial reporting.

2.30 Other respondents expressed concern that the preparation of donor statements could be onerous, especially where donors' reporting and auditing requirements differ. However, some respondents acknowledged that if a donor statement could be developed that would meet the reporting and auditing requirements of major donors, this could lead to an overall reduction in the reporting burden.

2.31 The INPAG Secretariat proposes exploring this issue with the Donor Reference Group. If sufficient progress is made, an additional section covering the use of a standardised format for optional donor and project reporting could be developed.

2.32 This process is expected to take some time, and consequently any additional section is not expected to be available for the first Exposure Draft (ED 1). Depending on the progress made, the section may be ready for inclusion in ED 3 or may need to be delayed until a later phase.

2.33 If an additional section is created current thinking is that the supplementary donor or project statements included as part of alternative 3 would be permitted but not required.

2.34 In the absence of an additional section covering the use of a standardised reporting format, the INPAG Secretariat proposes to develop generic guidance setting out the issues NPOs will need to consider in developing their own donor or project statements should they choose to do so.

Question 4:	What are the PAG's view on the proposals that a donor or project statement is optional and the Secretariat's proposed approach to its development?

Appendix A

Statement of financial performance

	Restricted Funds	Unrestricted Funds	TOTAL
Income			
Donations	100	25	125
Trading activities		15	15
Other income		3	3
Total Income	*100*	*43*	*143*
Expenses			
Raising funds		5	5
NPO activities	95	35	130
Other		4	4
Total Expenses	*95*	*44*	*139*
Surplus or (Deficit)	5	(1)	4