INTERNATIONAL FINANCIAL REPORTING
FOR NON PROFIT ORGANISATIONS

Practitioner Advisory Group

AGENDA ITEM: PAGED06-02
15 June 2022 – Online

Key numbers and terms in NPO Financial Statements

Summary	This paper proposes key numbers in NPO financial statements and outlines the key terms to be used in the financial statements.
Purpose/Objective of the paper	Seek input from the PAG members on the proposed key numbers in the financial statements and also seek input to enable the preparation of key terms for use in the financial statements.
Other supporting items	
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Actions for this meeting	Comment on the key numbers Advise on the key terms

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Key numbers and terms in NPO Financial Statements

1. Background

1.1 Financial statements of for-profit entities focus on key figures, such as turnover, gross and net profit, debt, equity and assets. Analysts use these numbers to calculate ratios such as margin %, return on investment, debt / equity, earnings per share and liquidity ratios. These priorities have shaped the structure of financial statements in the for-profit sector, and influenced norms and expectations for financial reporting in the non-profit sector also.

1.2 As the project has progressed, concerns have frequently been raised that the financial reporting terms used by the for-profit sector do not have meaning for the non-profit sector. We have seen this in our previous discussion about the name of the primary statement that sets out income and expenses in the reporting period. Alternative terms or guidance on the meaning of terms in an NPO context may therefore be required.

1.3 The IFR4NPO Project presents an opportunity to consider the numbers and terms that are most important in the non-profit sector, and to structure financial statements accordingly, within the bounds of agreed accounting concepts and principles.

2. NPO financial reporting terms

2.1 Much of financial reporting uses terms that have general applicability across all sectors of the economy. However there are a number of differences, which will be explored in the paragraphs below.

Restricted and unrestricted

2.2 The consultation paper discussed the separation of restricted from unrestricted funds. In the paper to the last PAG meeting, it was proposed that the separate presentation of income and expenses, net assets (and changes in net assets) for the aggregates of restricted and unrestricted funds would be required as a minimum. The same proposal was put to the TAG. Both bodies agreed with this approach.

2.3 To move this forward we need to agree what we mean by restricted and as a consequence what is meant by unrestricted. IPSAS 23 – *Revenue from non-exchange transactions* has the definitions in Table 1 below.

Table 1 – IPSAS 23 Definitions related to restrictions

Term	Definition
Conditions on transferred assets	stipulations that specify that the future economic benefits or service potential embodied in the asset is required to be consumed by the recipient as specified or future economic benefits or service potential must be returned to the transferor.
Restrictions on transferred assets	stipulations that limit or direct the purposes for which a transferred asset may be used, but do not specify that future economic benefits or service potential is required to be returned to the transferor if not deployed as specified
Stipulations on transferred assets	terms in laws or regulation, or a binding arrangement, imposed upon the use of a transferred asset by entities external to the reporting entity.

2.4 IPSASB is currently in the process of updating its standards relating to non-exchange revenue and transfer expenses. This work has created debate about the nature of the arrangement that needs to exist to consider an asset to effectively be restricted. IPSASB are moving away from consideration of performance obligations to compliance arrangements where the discussion has been around what constitutes an arrangement (legal or otherwise) and consideration of whether the arrangement includes specific rights and obligations which are enforceable through legal (or equivalent) means.

2.5 An alternate view on restrictions is provided by the UK Statement of Recommended Practice for charities, which adopts fund accounting. The definitions below are linked to UK trust law.

'Restricted funds may be either endowment or restricted income funds, depending on the nature of the restriction. ……. The resources (the assets and liabilities) of each restricted fund are held and maintained separately from other funds. This is in recognition of the circumstances in which the resources were originally received, and/or the restrictions on that fund that determine the way those resources are subsequently to be treated.'

'Unrestricted fund is a legal term for the unexpended resources held by a charity on trust, comprising money and other assets that can be used for any of the charitable aims of the charity. The use of unrestricted funds is not restricted to any particular charitable purpose of the charity.'

2.6 In Section 2 of INPAG which covers the concepts and pervasive principles, we are currently describing restricted and unrestricted funds as follows.

Restricted funds are established by the NPO because of an externally imposed funding or other legal arrangement that requires them to be expended, invested or retained by the NPO for a specific purpose. A breach of these externally imposed funding or other legal arrangements will usually require the NPO to return financial resources to those who provided them. The NPO may also face censure from regulators for the misuse of restricted funds, including the loss of regulatory and other financial privileges.

Unrestricted funds by contrast are described as those that are freely available to be utilised for any of the NPOs purposes. The NPO may internally designate these funds for a specific purpose, but there is no externally imposed funding or other legal arrangement that requires them to be used for this purpose.

2.7 These complexities are being considered purely from the perspective of what might be presented in the financial statements. Detailed proposals will be developed as part of the topics on non-exchange revenue and grant expenses that will be included in Exposure Draft 2. Definitions have been provided to help inform the discussion.

> Question 1: From an NPO perspective what are PAG members views on what is meant by restricted? What transactions would you expect to see within restricted income, expenses and net assets?

Equity

2.8 Equity is a term that is used in for-profit standards and is also included in the standards to be used by public sector entities. Equity is defined in the for-profit standards as the residual interest in the assets of the entity after deducting liabilities. This will include items that don't meet the definition of a liability such as share capital and will also include retained earnings and reserves e.g. revaluation reserve.

2.9 The standards for the public sector recognise that some entities may have share capital and uses the term net assets/equity as an equivalent term to the 'equity' section of the balance sheet of for-profit financial statements. IPSAS 1 – *Presentation of financial statements* uses the term defines net assets/equity as contributed capital, accumulated surplus or deficits, reserves and non-controlling interests.

2.10 Non-profit organisations will have a variety of different legal structures. Some may be incorporated entities, trusts or various forms of unincorporated entity. It is possible that some entities that meet the definition of an NPO using the characteristics previously discussed have some form of equity claims on the organisation, either from historic set up or because of jurisdiction specific legislation/regulation. However, it is not clear how common this will be.

2.11 The project secretariat is currently proposing to call the equivalent section in NPO financial statements 'net assets', with this comprising contributed capital, accumulated surplus or deficits split between restricted and unrestricted, reserves and non-controlling interests (for example a minority interest in an entity set up to support a number of non-profit organisations). Contributed capital would include all forms of equity claims including any shares that have been issued.

Question 2 – What are PAG member's views about the term 'equity' and the frequency of shares or contributed capital being part of an NPOs financial statements? What forms might contributed capital take? Are there other factors to consider?

Other issues

2.12 The purpose of financial statements is described in both IFRS and IPSAS standards as 'to provide information about the financial position, financial performance, and cash flows of an entity'. The use of the term 'financial performance' has attracted criticism from some stakeholders. The term 'in-year financial activity' could be used instead to include in year income and expenses.

2.13 The statement of financial position uses the terms, 'trade debtors' and 'trade creditors'. These are commonly understood terms in the preparation of accounts, but not all NPOs have 'trading' activity. If this is viewed as a significant issue these terms could be amended to 'receivables' and 'payables', which is consistent with the terms used in IPSAS.

3. Key numbers in the financial statements

3.1 General-purpose financial reports comprise both the financial statements themselves, as well as accompanying narrative reports or management commentary. The specific focus of this paper is the key figures in the financial statements with narrative reporting being considered in a separate paper.

3.2 There are trade-offs in the placing and profile of key figures, so prioritisation is critically important. For example, research in Australia and elsewhere has shown that a vast majority of users do not look at the notes to the financial statements at all and some users of the UK SORP accounts have complained that there are too many figures on the multi-column Statement of Financial Activities.

3.3 The table below shows potential key numbers for inclusion in NPO financial statements.

<table>
<tr><th></th><th>Number</th><th>Reason</th></tr>
<tr><td>1</td><td>Total expenses</td><td rowspan="2">Indicator of size, and context of the NPO’s operation</td></tr>
<tr><td>2</td><td>Total income</td></tr>
<tr><td>3</td><td>Unrestricted income</td><td>NPOs ability to cover costs that are not for a restricted purpose</td></tr>
<tr><td>4</td><td>Fundraising costs</td><td>Measure of investment to generate unrestricted income</td></tr>
<tr><td>5</td><td>Programme and admin expenses</td><td rowspan="2">Ability to reconcile to a specific donor supplementary statement</td></tr>
<tr><td>6</td><td>Capital expenditure from restricted grants</td></tr>
<tr><td>7</td><td>Unrestricted surplus or deficit</td><td>NPO’s ability to manage its finances and generate reserves</td></tr>
<tr><td>8</td><td>Net assets (equal to total equity or funds)</td><td>Indicator of going concern and proxy for size</td></tr>
<tr><td>9</td><td>Unspent grants</td><td>Funds to be accounted for in future periods</td></tr>
<tr><td>10</td><td>Unrestricted general reserves</td><td>Measure of financial sustainability</td></tr>
<tr><td>11</td><td>Transactions or balances with directors or senior management</td><td>Transparency about potential conflicts of interest or abuse of fiduciary responsibility.</td></tr>
</table>

3.4 In discussion with donors the emerging view is that the numbers which are of greatest significance are total income and expenses and the extent of unrestricted reserves, which many see as an indicator of resilience.

3.5 Capital expenditure from restricted grants has been highlighted as a particular issue, given many donors like to see the total value of asset expenses to demonstrate how the grant has been used. Whilst it may not be possible to show this as an expense in the Statement of income and expenses, there may be options to look at how this features in the Statement of cashflows.

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Question 3: What are your views on the usefulness of these numbers to users of NPO financial statements, both the primary statements and the notes to the accounts? Should any of these numbers be for the narrative report?

Question 4: Are there other useful key figures that might reasonably be included in NPO general-purpose financial statements? If so, why?

Question 5: Which three figures do PAG members think would be most valuable and deserving of prominence in NPO general purpose financial statements?

June 2022

ANNEX

Additional contextual information for key numbers

The Consultation Paper chapter 2 addressed who the users of general-purpose financial statements are. While the final wording is still under development, the following are the working assumptions as context for a conversation about their information needs:

Primary users of NPO financial reports (external stakeholders that lack the power or authority to require information to meet their specific needs)

- Service users, (also referred to as clients, beneficiaries, affected communities), and those that might represent them
- Prospective donors, (individuals and prospective grantors)
- Suppliers, credit providers

Secondary users of NPO financial reports (stakeholders that technically do, or may have the power or authority to require information to meet their specific needs)

- Trustees or Directors charged with governance
- Sector regulators / tax authorities
- Current donors/grantors
- Employees, collaborating partners

Society more broadly, where trust in non-profits is necessary for an optimally functioning sector.

Current grantors and donors are considered secondary users because their needs can potentially be met with specially requested information. However, there are significant costs and burdens associated with multiple requirements born by both grantors and grantees. These costs and burdens may be mitigated to the extent that common needs could be met in the general-purpose financial reports.

The Consultation Paper chapter 2 also addressed the information needs of users of the financial reports, if they are to support decision making and accountability. It was proposed that external stakeholders need to know that an NPO is achieving its objectives, in a way that maximises economy, efficiency and effectiveness in the use of resources, while complying with restrictions and regulations, and in the context of its longer-term financial health.