

Technical Advisory Group

Issue Paper

AGENDA ITEM: TAGED08-02
29 and 30 September 2022 – Hybrid

ED1 –Terminology and concepts

<p>Summary</p>	<p>This paper focuses on the most significant comments raised by TAG members to ED1 in relation to terminology and concepts included in Section 2 <i>Concepts and Pervasive Principles</i>. These have been grouped under the following headings:</p> <ul style="list-style-type: none"> • Service potential; • Funds with restrictions and funds without restrictions; • Ownership, including contributed capital and the position of ‘service beneficiaries’; and • Glossary. <p>For each area we provide an overview of the feedback received from TAG members, the proposed approach taken to updating the ED to reflect this feedback, and any remaining questions to TAG members.</p>
<p>Purpose/Objective of the paper</p>	<p>To provide TAG members with an opportunity to understand comments raised on the draft of ED1 in relation to Section 2 <i>Concepts and Pervasive Principles</i>, to provide feedback on the approach to responding to these comments proposed by the Secretariat, and to respond to the questions that will enable the finalisation of the ED.</p>
<p>Other supporting items</p>	<p>TAGED08-01 <i>Revenue</i>, TAGED08-04 <i>Structure of ED1</i></p>
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<p>Actions for this meeting</p>	<p><u>Comment</u> on the proposed approach to responding to TAG comments raised to ED1 in relation to Section 2 <i>Concepts and Pervasive Principles</i> and <u>Advise</u> on the questions raised.</p>

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ED1 – Terminology and concepts

1. Introduction

- 1.1 The TAG was provided with a full draft of ED 1 in July 2022. This comprised:
- Draft of the invitation to comment with the authoritative guidance;
 - Draft basis for conclusions; and
 - Draft implementation guidance.
- 1.2 Feedback on these documents was requested by end of August 2022 to frame discussions that would enable a fatal flaw review of the key components of ED1 at the 29/30 September 2022 TAG meeting. This paper focuses on the most significant comments that were raised by TAG members in relation to terminology and concepts included in Section 2 *Concepts and Pervasive Principles*. These have been grouped under the following areas:
- Service potential and measurement;
 - Funds with restrictions and funds without restrictions;
 - Ownership, including contributed capital and the position of ‘service beneficiaries’; and
 - Glossary
- 1.3 For each area we provide an overview of the feedback received from TAG members and the proposed approach taken to updating the ED to reflect this feedback. Questions are also posed to TAG members to give an opportunity for advice to be provided that will enable the finalisation of the ED.

2. General point on concepts and pervasive principles

- 2.1 Before examining the individual areas, it is worth reiterating the approach that is being taken to using the *IFRS for SMEs* Accounting Standard as the foundational framework of INPAG and the purpose of providing concepts and pervasive principles.
- 2.2 It was agreed that due to financial and time constraints that INPAG would be developed by using existing international financial reporting standards, and that the *IFRS for SMEs* Accounting Standard was the most appropriate foundational framework. The approach agreed to making changes to the *IFRS for SMEs* Accounting Standard is that such changes would only be made where they are necessary for the NPO context, otherwise the text from the *IFRS for SMEs*

Accounting Standard would be brought into INPAG without amendment (see TAGED08-04 *Structure of ED1*).

- 2.3 It was also agreed with TAG members that where a term is already used by international financial reporting frameworks, INPAG would define and use that term in the same way as those frameworks.
- 2.4 The *IFRS for SMEs* Accounting Standard is being updated, and its Section 2 *Concepts and Pervasive Principles* now more closely aligns with the Conceptual Framework that is applicable to IFRS Accounting Standards and the IPSASB Conceptual Framework. While this has brought Section 2 *Concepts and Pervasive Principles* in the *IFRS for SMEs* Accounting Standard up to date with other international financial reporting frameworks, it has made it more detailed and technical.
- 2.5 As TAG members will know, conceptual frameworks set out fundamental concepts and principles that guide the development of standards. This is to ensure that those standards are conceptually consistent and that similar transactions are treated in the same way, and assist entities in developing accounting policies where no standard applies to a particular transaction. By their nature they are therefore aimed at a technical audience.
- 2.6 Section 2 *Concepts and Pervasive Principles* of INPAG is also therefore primarily aimed at a technical audience. It is guiding the Secretariat and TAG in the development of financial reporting guidance in individual sections, particularly where a change is required to the *IFRS for SMEs* Accounting Standard for the NPO context. It will also assist financial accountants in NPOs in devising accounting policies where necessary.
- 2.7 Some TAG members provided feedback that this Section in particular was too long. Views were expressed that much information could be removed as it is not needed, and that technical accounting terms could be reduced with more use made of plain English. While the Secretariat shares the aim of making the Guidance as simple, understandable and accessible as possible, given the approach agreed to amending the *IFRS for SMEs* Accounting Standard and the purpose of this Section it is deemed appropriate that this Section is aimed at a more technical audience.
- 2.8 The Secretariat is, however, working to ensure that the Application Guidance will provide advice on the *Concepts and Pervasive Principles* that will be more understandable to the lay user and will make the Section easier to apply by those who do not have a technical financial reporting background.

Question 1: Do TAG members have any comments on the Secretariat's approach to Section 2 *Concepts and Pervasive Principles*?

3. Service potential and measurement

- 3.1 Service potential was introduced in the draft Concepts and Pervasive Principles as part of the definition of an asset where it is noted that 'an economic resource is a right that has the potential to produce economic benefits or service potential.' Economic benefits are defined as being related to cash inflows or a reduction in cash outflows. Service potential is defined as being related to the capacity to provide services that contribute to achieving the NPO's objectives. As noted, service potential therefore enables an NPO to achieve its objectives without necessarily generating net cash inflows.
- 3.2 Whilst there is agreement as to the inclusion of service potential as a concept, a number of comments were raised by TAG members with respect to how it has been incorporated into the Concepts and Pervasive Principles. These comments were primarily with respect to:
- whether service potential is separate to economic benefits or should be seen as part of it alongside cash inflows and cash outflows;
 - if enough examples of service potential had been included to enable users of INPAG to understand the concept and its application; and
 - how service potential had been introduced into areas such as recognition and measurement where amendments had been made to the *IFRS for SMEs* Accounting Standard text.
- 3.3 In determining whether service potential is separate to economic benefits or should be seen as part of it alongside cash inflows and cash outflows, the position in IFRS and IPSAS has been re-examined. IFRS is silent on the concept, but the IPSASB includes service potential as a separate concept and detailed in their basis for conclusions in the Public Sector Conceptual Framework their reasoning for doing so.
- 3.4 The IPSASB acknowledged that there is an argument that service potential is part of economic benefits, but wanted to bring out the concept separately because many of the respondents to its Conceptual Framework consultation paper and exposure draft supported the inclusion of service potential as a standalone characteristic of an asset. For the IPSASB, this approach acknowledges that the primary objective of most public sector entities is to deliver services, but allows that public sector entities may also carry out activities with the sole objective of generating net cash inflows.

- 3.5 The primary objective of NPOs is to deliver goods and services for the benefit of the public. This may involve assets being used primarily for their capacity to provide services instead of, or as well as, to generate net cash inflows. The position of NPOs is therefore analogous to public sector entities.
- 3.6 Conceptually, as noted above, it has previously been agreed with the TAG that where a term is already used in international standards INPAG will maintain a common definition and use. Service potential is defined separately to economic benefits in the IPSASB Conceptual Framework and is used separately to economic benefits in a number of IPSAS Standards. INPAG will draw upon some of these areas, such as the measurement of assets and revenue. It is therefore proposed that service potential is retained as a separate concept alongside economic benefits. This was supported by the PAG, who were strongly of the view that service potential is an important concept for NPOs.
- 3.7 G2.54 where service potential is introduced, will be amended to explain the concept as follows:
- “An economic resource is a right that has the potential to produce economic benefits or to provide services and goods in accordance with the NPO’s objectives. Economic benefits may relate to cash inflows or a reduction in cash outflows. The capacity to provide services and goods that contribute to achieving the NPO’s objectives is service potential. Service potential enables an NPO to achieve its objectives without necessarily generating net cash inflows.”*
- 3.8 Additional examples will be provided in G2.55 of rights that have the potential to produce service potential, and references to service potential throughout the rest of Section 2 *Concepts and Pervasive Principles* checked to ensure they are appropriate and align with this approach.
- 3.9 It is recognised that including service potential as a separate concept to economic benefits may cause some difficulty for respondents to ED1. This is because the detail of how service potential will apply in the NPO context for the measurement of assets held for their service potential has not yet been developed. This will be covered in relation to revenue in ED2 and inventory in ED3. It is not currently proposed to update Section 17 on Property Plant and Equipment as part of Phase 1, but this will be the priority area should resources allow.
- 3.10 The Basis for Conclusions will be updated to provide a discussion of this position and how it will be addressed in future EDs.

Question 2: Do TAG members agree with the Secretariat’s proposal to maintain a definition of service potential separate to economic benefits?

4. Funds with restrictions and funds without restrictions

- 4.1 Section 2 *Concepts and Pervasive Principles* does not define net assets as a financial statements element but indicates that it is residual of recognised assets minus recognised liabilities. It notes that net assets may be managed by an NPO in separate funds. These may be funds with restrictions and funds without restrictions.
- 4.2 TAG members noted in their feedback that there needed to be greater clarity regarding the components of these funds, including how items such as endowments and funds set aside for providers of contributed capital would be treated. There were further comments on how these funds would be presented in the financial statements, and whether fund accounting was effectively going to be mandated.
- 4.3 The intention is that funds with restrictions and funds without restrictions would encompass all net assets other than contributed capital and any non-controlling interest recognised by an NPO.
- 4.4 In funds with restrictions this would include all funds that are based on restricted income received by the NPO including items such as endowment funds whether these are permanent or expendable. Funds without restrictions would include internally designated funds and any remaining net assets that are not covered by either internal designation or externally imposed restrictions. Funds without restrictions are also likely to include any revaluation reserves and defined-benefit pension assets or liabilities recognised by the NPO. Where these reserves relate to assets recognised in a fund with restrictions, or staff working on a long-term project funded by restricted revenue, there may, however, be a case for recognising the relevant parts of these reserves in funds with restrictions. TAG feedback is sought on this issue.
- 4.5 Where funds set aside for providers of capital contributions exist it is possible that these may be within funds without restriction if these are the choice of the NPO, or funds with restrictions if these are based on a legal or regulatory requirement. The basis for conclusions has been amended to discuss this possibility and SMC 2g added to take this into consideration.

Question 3: Do TAG members agree with the Secretariat's responses to views on the description of the issue?

- 4.6 From a presentation perspective, the statement of financial position will only show the overall net position of funds with restrictions and funds without restrictions. A breakdown of these funds may be included in the statement of

movement of net assets or in the notes to the financial statements, where they are material, or where an NPO chooses to disclose them. Further information is provided in the relevant Sections that cover the individual financial statements. As a consequence fund accounting is effectively being mandated, but the approach is to focus on aggregates of funds with a requirement to disaggregate only when material.

- 4.7 It is also the intention that where an NPO does have elements such as assets and revenue that are covered by restrictions, then it will be a requirement for the NPO to recognise and disclose this within funds with restrictions as appropriate for each primary financial statement.
- 4.8 TAG members also commented on the definition of the term 'restriction'. The first issue relates to clarification of 'externally-imposed'. One TAG member noted that some confusion in their jurisdiction can occur when restrictions are set by the Board of Directors (particularly where the Board is comprised mainly of members external to the organisation), so their standards specifically clarify that such restrictions are internal. Text on has been included to reflect this in funds without restrictions in G2.79.
- 4.9 Another TAG member noted that it may be necessary to distinguish a requirement to return financial resources if there is a breach of funding or other legal requirements, separate to a requirement to return funds if they are not spent. The Secretariat's initial view is that a requirement to return funds if they are not spent is a restriction as the NPO is not free to utilise the resources for any of its purposes or activities. TAG views on whether this clarification is required is sought and if so, whether it should be included in the core text or Application Guidance.
- 4.10 A question was also raised with respect to restricted donations, performance related conditions and the definition of a liability. The key issue here is about the definition of a liability and whether a restriction creates an obligation. This relates primarily to non-exchange revenue discussed in TAGED08-01 *Revenue*. The Secretariat considers that a restriction that is not a performance-related condition will not give rise to a liability. Restrictions that limit or direct the purpose to which an economic resource may be used will not prevent the recognition of revenue, although it will be reported as restricted, and will not lead to the recognition of a liability. Whilst the definition of a liability could be updated as part of ED2, as a key concept that frames the development of other sections of INPAG, it would be highly beneficial to have TAG views on this as part of ED1.

Question 4: Do TAG members agree with the inclusion of text to clarify the internal nature of decisions made by Board of Directors/those charged with governance over the allocation of funds?

Question 5: Do TAG members support the inclusion of text clarifying the position over funds that must be returned if they are not spent by the NPO? If so, do TAG members support its inclusion in the Application Guidance?

Question 6: Do TAG members agree with the definition of a liability given the issues discuss in the TAGED08-01 *Revenue*?

5. Ownership, including contributed capital and the position of 'service beneficiaries'

- 5.1 Section 2 *Concepts and Pervasive Principles* removes equity as an element of financial statements. Instead of equity INPAG includes a new element of contributed capital, which has a slightly different conceptual basis. Equity in the *IFRS for SMEs Accounting Standard* is defined as the residual interest in the assets of the entity after deducting all its liabilities. Equity was removed as an element because of the implication that the residual interest will be due to the ultimate owners of the entity. This is not considered to reflect the NPO context, where ownership for returns is not the primary objective. An element is, however, required to reflect the possibility that a party external to the NPO may have some financial interest in the net assets of the NPO.
- 5.2 Some TAG members questioned whether contributed capital would exist in the NPO context and if it did exist, they noted that examples should be provided to demonstrate what form contributed capital would take.
- 5.3 One of the broad characteristics that describes NPOs is that organisations will not have the primary objective of distributing surpluses for private benefit to groups and individuals such as investors and holders of equity claims. Therefore, it is not expected that contributed capital will exist for many NPOs and, if it does so, it is not expected to be significant. A TAG member, for example, noted that for most NPOs where initial start-up funding is provided by an external party or parties, this will give those external parties some governance rights but will not give them a financial interest in the net assets of the NPO. In this case contributed capital will not exist.
- 5.4 In recent discussions with the PAG, they outlined several possible arrangements where the provision of funding will provide an interest in the net assets of the NPO. These included share capital in the context of charitable companies and some foundations, and funds contributed by members in membership

organisations and mutuals, which provide entitlement to distributions and a share of net assets in the event of dissolution.

- 5.5 The nature of some of these arrangements could lead to a question as to whether the entity should be described as an NPO, particularly if the level of contributed capital, the entitlement to distributions and a share of net assets is significant. It is clear though that there are jurisdictions where entities recognise the equivalent of what has been defined for the INPAG as contributed capital and yet those entities are required to follow financial reporting standards for NPOs.
- 5.6 It is proposed that contributed capital is retained as an element and that examples are provided of the form that contributed capital may take. Further amendments have made to the text of Section 2 *Concepts and Pervasive Principles* to clarify that contributed capital is the element, and capital contributions and capital distributions represent changes in contributed capital. See G2.73-G2.76.
- 5.7 In addition to contributed capital, a second 'ownership' related question was raised with respect to the accumulated funds of the NPO. The TAG was asked whether 'service beneficiaries', being the individuals, groups or organisations that are in receipt of services, goods, or advocacy of an NPO, should be seen as the equivalent of owner and entitled to the accumulated funds of the NPO.
- 5.8 It is clear from the feedback provided that surpluses or deficits generated over time do not create any rights or entitlement by service recipients over the NPOs net assets. If such entitlements did exist, they would be expected to be recognised as liabilities. The PAG were in agreement with this position. As such the proposal to note that 'service beneficiaries' may be seen as the equivalent of owners has been removed.

Question 6: Do TAG members agree that contributed capital should be an element?

Question 7: Are TAG members content that the examples provided represent contributed capital?

6. Glossary

- 6.1 There were also a number of comments on the definitions included within the glossary. The feedback and revised definitions are included in Annex A to this paper.
- 6.2 New terms were proposed for economic phenomena, exchange transactions and non-exchange transactions. Secretariat agrees that these should be added.



Question 9: Do TAG members agree with the revised definitions?

Question 10: Do TAG members agree with the inclusion of the additional terms and if so, the definitions proposed?

7. Material to review

- 7.1 The ED has been updated to reflect the proposed approach to the feedback from the TAG on these issues and other less substantive issues and editing requests. A full redraft is provided as a separate resource for the meeting. The points addressed in this paper related mainly to Section 2 *Concepts and Pervasive Principles*. Tracked changes will show the edits made.

September 2022

Annex A: Glossary

Term	Feedback	Revised definition
Beneficial interest	Instead say "that arises other than through equity ownership"	An interest held by an NPO in the net assets of another entity that arises other than through equity ownership.
Capital distributions	As Section 7 talks about capital distributions <i>received</i> by the NPO, consider a more generic definition, or perhaps have two elements to it "an outflow of resources...etc or an inflow of resources to an NPO."	An outflow of resources from an NPO, distributed to parties external to the NPO, which returns or reduces a financial interest in the net assets of the NPO. It may also be an inflow of resources to an NPO in return for its financial interest in the net assets of another entity (for example, a dividend received).
Contributed capital	Remove and/or	Future economic benefits or service potential that has been contributed to an NPO by parties external to the NPO, other than those that result in liabilities of the NPO, that establish a financial interest in the net assets of the NPO, which: (a) conveys entitlement both to (i) distributions of future economic benefits or service potential by the NPO during its life, such distributions being at the discretion of the NPO, and to (ii) distributions of any excess of assets over liabilities in the event of the NPO being wound up; and/or (b) can be sold, exchanged, transferred, or redeemed.
Economic phenomena	Proposed new term	Economic phenomena are economic resources, claims against those resources, and the effects of transactions and other events and conditions that change those resources and claims.
Exchange transactions	Proposed new term	Exchange transactions are where an entity receives value from another party and gives approximately equal value in exchange.
Funds with restrictions	Flipping the order of this definition would improve its readability,	Funds that are required to be expended, invested or retained by the NPO for a specific purpose or activity as a consequence of externally imposed funding or other legal arrangements placed on the NPO by a resource provider.
Funds without restrictions	Adding '.... and are therefore not funds with restrictions' would emphasise the difference between both terms.	Funds that are freely available to be used by an NPO for any of its purposes or activities. An NPO is free to internally designate funds for a specific purpose or activity, (including designation by the NPO's board of directors), but the absence of any externally imposed funding or other legal arrangement means that they are not required to be used for this purpose or activity and are therefore not funds with restrictions.
Non-exchange transactions	New term needed	Non-exchange transactions are where an entity receives value from another party without giving approximately equal value in exchange.



Other comprehensive income	Do we need this?	Items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by the <i>IFRS for SMEs</i> Accounting Standard.
Owners	Might clarify that this standard uses a different word for the “owners” of an NPO. Or delete this definition.	Holders of instruments classified as equity other than holders of instruments classified as equity in an NPO who are the holders of contributed capital.
Parent	Might clarify here that in this standard the term “investor NPO” is used where a parent is an NPO. Or delete this definition.	An entity that has one or more subsidiaries or controlled entities. The term ‘investor NPO’ is used where an NPO is a parent.
Reporting NPO	“...or part of NPO or multiple NPOs” to align to the wording above.	A reporting NPO is a single NPO, part of an NPO or a combination of NPOs that is required, or chooses, to prepare general purpose financial reports.
Societal accountability	Doesn't appear to be used anywhere in the Guidance.	An expansive view of accountability that recognises a general accountability to society at large due to the importance of NPO goods and services, the funding environment, the preferential treatment that NPOs can receive compared to other organisations, and the need to ensure the effective operation of the wider sector.
Statement of financial position	In other places in the guidance the term “providers of contributed capital and/or service beneficiaries” is used	A financial statement that presents the relationship of an entity's assets, liabilities and interests of providers of contributed capital as of a specific date (also called the balance sheet).
Statement of income and expenses	Proposed amends to the text	A financial statement that presents all items of income and expense recognised in the period, except for items of income and expense explicitly required to be recognized in the statement of changes in net assets and totals to the surplus or loss for a period.
Total comprehensive income	It may be that this definition can be deleted entirely if the income statement stops earlier on.	The change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners (equal to the sum of profit or loss and other comprehensive income) as defined by the <i>IFRS for SMEs</i> Accounting Standard.