

# Part 1: General NPO financial reporting issues

Response from ICAS to the IFR4NPOs Initiative

15 July 2021



# Introduction

ICAS is a professional body for more than 22,000 world class businesspeople who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business; many leading some of the UK's and the world's great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have over 4,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

## General comments

The ICAS Charities Panel welcomes the opportunity to comment on the first consultation conducted by the International Financial Reporting for Not-for-Profit Organisations (IFR4NPOs) Initiative which considers broad questions about the financial reporting framework likely to form the basis of formal Guidance for Not-for-Profit Organisations (NPOs).

We support the inclusion of narrative reporting within the proposed scope of the guidance for NPOs and we also support using the International Financial Reporting Standard for Small and Medium-sized Entities (the IFRS for SMEs) as the basis of the financial reporting framework being developed as part of the Initiative.

We recognise that the IFR4NPOs Initiative is not a standard setting board and therefore is unable to issue narrative/ corporate reporting standards or financial reporting standards for NPOs. This means that the output from the Initiative will be formal Guidance.

Included in the Annex are details of the information requested from all participants and we set out our responses to the consultation's general matters for comment below.

## Responses to general matters for comment

### General matter for comment 1

1.a. Do you agree with the broad characteristics proposed in Chapter 1 (of the consultation paper) for describing NPOs? If not, why not? Which alternative characteristics would you propose, and why?

### Response to general matter for comment 1

The Panel supports a 'broad characteristics' approach but would also support a requirement that as a minimum an NPO applying the guidance should have an asset lock i.e., should not be permitted by law or its founding documents to distribute surpluses to individuals or to commercial profit distributing entities.

As the NPO Guidance is intended to be suitable for application in any jurisdiction and not all jurisdictions have a legal framework for charities/ NPOs, a 'broad characteristics' approach is appropriate. For example, there is no mention of charitable objects in the proposed broad characteristics, and this make sense if the Guidance is to be capable of application by NPOs in many countries.

We considered whether, under the 'broad characteristics' approach likely to be followed by the Guidance, whether the Guidance should be targeted solely towards NPOs which are for public benefit. However, we concluded that this should not be the case as there are entities such as trade unions which are for private benefit but have an asset lock and may, therefore, benefit from applying the NPO Guidance.

Therefore, we would recommend that further consideration is given to extending the envisaged scope of the NPO guidance to encompass entities which are not public benefit entities, except where jurisdiction specific legislation is in place. For example, to trade unions as mentioned above, trade associations, political organisations, non-charitable campaigning bodies and think tanks. However, we would not see private members clubs as falling within the scope of the guidance.

### **General matter for comment 2**

2.a. Do you agree that NPOs are accountable to service users, resource providers, and regulators and have societal accountability? If not, why not? What alternative groups would you propose NPOs can be accountable to, and why?

2.b. Do you agree that external stakeholders require information on an NPO's achievement of objectives, economy efficiency and effectiveness, compliance with restrictions and regulations, and longer-term financial health, for accountability and decision-making purposes? If not, why not? What alternative areas would you propose and why?

2.c. Do you agree with the issues that have been identified with current accountability and decision-making arrangements for NPOs? If not, why not? Are there any other issues with current accountability and decision-making arrangements, particularly financial accountability to donors, that you would wish to highlight?

### **Response to general matter for comment 2**

2.a. We believe that there is a difference between being accountable to others for your activities and owing a duty of care to individuals, groups (including taxpayers) or other entities in relation to the content of a narrative annual report and financial statements. Annual reports and financial statements are for a general purpose and, therefore, NPOs do not normally owe a duty of care to any individual, group, or entity in relation to their report and financial statements, except for NPOs which have a membership based constitution.

However, we agree that the main users of reports and financial statements (described collectively in the consultation paper as financial reports) should be identified and considered when developing the Guidance for NPOs as this should inform the development of the Guidance.

We agree that service users, resource providers and regulators are or should be key/ main users of NPO reports and financial statements. However, it may be helpful to extend the definition of resource providers, beyond funders etc and providers of finance, to include suppliers of goods and services or to include suppliers of goods and services as a separate group of key/ main users. We mention this due to the emphasis placed on the decision-usefulness of NPO reports and financial statements in the consultation paper.

Also, not all NPOs provide services in the traditional sense, therefore, using the broader term 'beneficiaries', in addition to or instead of service users, is worth considering and this could potentially be extended to anyone who is the legal guardian of a beneficiary or who is otherwise advocating on their behalf. Potential providers of resources may be another key group the Initiative may wish to consider adding to the list of key users of annual reports and financial statements.

If the NPO Guidance is developed with these key/ main users of annual reports and financial statements in mind, we believe that the needs of wider society as far as these are known, and can be met through this medium, should be capable of being met in relation to the content of NPO annual reports and financial statements.

2b. The consultation paper explores what external stakeholders need for accountability and decision-making and sets out the following four key themes:

- Achievement of objectives.
- Economy, efficiency, and effectiveness.
- Compliance with restrictions and regulations.
- Longer-term financial health.

We are not convinced that this topic is being approached in the most effective manner. We recognise the increasing emphasis on narrative reporting and support a more holistic approach to the annual report and financial statements, for example, through the annual report and financial statements together saying something about an entity's long-term financial sustainability.

However, we believe that the following need to be treated as distinct objectives: the objectives of standard setters (or similar); the objectives of standards (or guidance); the objectives of annual reports and; the objectives of financial statements. It is not clear from the consultation that such distinctions are being made. However, we refer again to the idea of a combined objective for NPO financial reports in our response to general matter for comment 2c.

Standards (or guidance) are how standard setters (or similar) achieve their overall objectives while annual reports and financial statements are the ultimate outputs of the standard setting (or guidance setting) process.

Therefore, for this exercise, we believe that it would be appropriate to set out separately the objectives of the NPO Guidance, the objectives of the annual report and the objectives of the financial statements. We also say more on this topic in our answer to general matter for comment 2c.

With the regard to the four themes mentioned above, we have the following comments:

- The four themes appear to relate mainly to narrative annual reports rather than to financial statements. However, we believe that the emphasis should be placed on financial statements as it will be guidance on financial reporting which forms most of the material within the planned NPO Guidance.
- The term 'performance against objectives' would be preferable to 'achievement of objectives' as this would better recognise that objectives are not always achieved. In addition, we would welcome a requirement for NPOs to report what difference they have made (i.e., their impact) in their annual report.
- Economy, efficiency, and effectiveness are the terms used in the UK to mean value for money. We do not think that demonstrating value for money works as an objective for an NPO's annual report and financial statements. We believe that through a combination of performance/ impact reporting and a robust financial review, an NPO should be able to demonstrate the difference it has made and its financial health, including its longer-term sustainability, encompassing its longer-term financial sustainability. While we refer to longer-term sustainability, we recognise that there may be instances where NPOs are established to deliver short-term specific objectives and when these are met the NPO may be wound up.
- Auditing standards do not require the annual report as a whole to be audited, therefore, statements about value for money by an NPO could challenge the current auditing framework and could increase the risk that the governing body may not report objectively about its activities and performance.
- We believe that it would be helpful for NPO annual reports and financial statements to place an emphasis on the reporting of an NPO's funds, including, commentary on whether or not any 'restricted funds' have been spent for the purposes intended. This may reduce funder requests for additional separate reports. However, reporting will need to be proportionate in recognition that an NPO's annual report and financial statements are for a general purpose. Narrative information about an NPO's funds more generally should be part of a broader narrative about an its ability to continue as a going concern and its longer-term sustainability, including its longer-term financial sustainability. We will comment further on the topic of fund accounting in our response to Part 2 of the consultation.

- Including compliance with restrictions and regulations gives a nod to the ‘regularity opinion’ that the auditors of some UK public bodies are required to give. Therefore, care needs to be taken as to how compliance with restrictions and regulations will be handled within the scope of an NPO’s annual report and financial statements. For example, it would not seem appropriate for an NPO’s annual report to include a statement to the effect that all regulations had been complied with. We do not believe that the annual report is the correct place for such a statement, and this could cause similar challenges for the auditor as statements from the governing body about value for money. Also, we would not support the annual report and financial statements document being a substitute for the gathering of information specifically to meet the needs of regulators.

2.c. We do not believe that the consultation paper addresses issues in relation to accountability and decision-making correctly. Insufficient emphasis is placed on accountability, and we believe that ‘stewardship’ is a more suitable term than ‘accountability’ when considering the objectives of the financial statements. ‘Accountability’ is a term more suitable in looking to the past but ‘stewardship’ while relevant to the past also points to the future sustainability of an entity. It also follows, that we are of the view that too much emphasis is placed on decision-usefulness in the consultation paper.

IFRS for SME specifically highlights that the objective of financial statements is for economic decision-making, with stewardship given less emphasis:

“The objective of financial statements of a small or medium-sized entity is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users of the financial statements who are not in a position to demand reports tailored to meet their particular information needs.

Financial statements also show the results of the stewardship of management—the accountability of management for the resources entrusted to it.”

The relative priority given to economic decision-making and stewardship makes sense for the financial statement objectives of profit distributing entities. However, creating combined objectives for NPO annual reports and financial statements with a prominent decision-making objective broader than economic decision-making may not be the correct approach, especially without first considering the objectives of annual reports and financial statements separately.

Given the different nature of their content and the specific responsibility of governing bodies preparing accruals-based financial statements to ensure that they ‘present fairly etc’ or give a ‘true and fair view’, setting separate objectives for NPO financial statements is especially important. Also, more clarity is needed as to how the Initiative believes NPO financial statements will support decision-making in a broader sense than ‘economic’.

Requiring specific consideration is the extent to which the balance sheet approach to the IFRS for SMEs, which contributes to financial statements being useful for the economic decisions of investors and suppliers, can be translated as being useful to the economic decisions and non-economic decisions made by users of NPO financial statements. Where the final NPO Guidance departs from the use of fair values (for example, in relation to any concessions made available to smaller or less complex NPOs from measuring assets and liabilities at fair value), the impact of doing so on the decision-usefulness of NPO financial statements needs to be considered in developing NPO financial statement objectives.

It is important that the NPO Guidance includes financial statement objectives which will enable the governing body to prepare accounts which present fairly the financial position, performance and cash flows of the entity. Consideration may also need to be given as to how the financial statement objectives could also be applied where jurisdictions require financial statements to give a ‘true and fair’ view if the Guidance is likely to be applied in such jurisdictions.

Returning to the topic of combined objectives, the boards of premium listed UK companies are required to make a statement that the annual report and financial statements, taken together, are fair balanced and understandable. The concept of ‘fair, balanced and understandable’ may be helpful in thinking about the combined objectives of NPO financial reports.

### **General matter for comment 3**

3.a. What, if any, do you see as the main challenges with Guidance that is accrual-based?

3.b. What, if any, do you see as the main challenges with Guidance that includes non-financial information reporting?

### **Response to general matter for comment three**

3.a. Our response to this question is based on our support for NPOs preparing their financial statements on an accruals basis. Also, the challenges we raise are in relation to jurisdictions which may be looking to implement an accruals-based framework for NPOs for the first time and we have viewed the topic of challenges in the broadest sense.

We have identified the following key challenges for the successful implementation of Guidance that is accruals-based:

- In some jurisdictions gathering all the information needed to prepare accruals-based financial statements could create practical challenges and, in some jurisdictions, will unfortunately not be realistic. The completeness and adequacy of accounting records and the implementation and operation of financial controls is an issue in some jurisdictions even in respect of cash-based financial statements so accruals-based financial statements will pose additional challenges due to increased information needs. For accruals-based financial statements which take a balance sheet approach, identifying the fair value of assets and liabilities may pose a particular additional difficulty.
- Education and training could be a significant challenge in some jurisdictions to the adoption of accruals-based Guidance for NPOs. However, basing the Guidance on the IFRS for SMEs increases the likelihood that accountants who apply the Guidance will have a reasonable knowledge and understanding of it.

3.b. In terms of preparing Guidance on non-financial reports, preparing guidance on performance and impact reporting is likely to create the biggest challenge, given the diversity of the entities and range of jurisdictions which may apply the Guidance. From the perspective of users of the Guidance, they will face the same inherent challenges in developing meaningful performance and impact reporting measures as those in jurisdictions with more established narrative reporting frameworks. There may be challenges in establishing systems and processes to gather information and establishing internal controls around these. The governing body will need to be satisfied about the completeness and accuracy of performance and impact reporting data. Some latitude may be needed within the Guidance to enable NPOs to take a pragmatic approach so that any performance or impact reporting requirements do not become a barrier to adopting the Guidance.

### **General matter for comment 4**

4.a. Do you agree that international frameworks are the best start point for the Guidance? If not, why not?

4.b. Do you agree with the criteria that have been used to assess the suitability of the existing international frameworks? If not, why not and what other criteria do you believe could be used and why?

4.c Do you agree with the high-level assessment of the existing international frameworks against these criteria? If not, why not? What assessment would you make and why?

### **Response to general matter for comment 4**

4.a. We agree that international frameworks are the best starting point for the NPO Guidance, with the IFRS for SMEs as the foundational framework.

We note that the proposals do not mention tiering i.e., concessions for smaller or less complex NPOs and we recommend that these are considered when developing the Guidance. We provide additional comments about tiering in our response to question 5.

We believe it may be necessary to simplify some of the requirements in the IFRS for SMEs for smaller or less complex NPOs in some areas, for example, around fair value measurement and around disclosure requirements. Consideration could also be given to developing cash-based or modified cash-based guidance for smaller or less complex entities as part of a tiered approach.

4.b We broadly support the criteria used to assess the suitability of existing international frameworks by analysing how relevant they are in respect of priority issues identified. However, there are differences between the priority areas identified in the consultation paper's executive summary and in figure 4.3 'Relevance of guidance provided by international frameworks to NPO-specific issues'.

The executive summary identifies the following priority issues:

- Reporting entity.
- Accounting for incoming resources.
- Accounting for outgoing resources.
- Accounting for financial and non-financial assets.
- Presentation, scope, and content of financial reports.

However, figure 4.3 does not address accounting for financial assets which we believe is a difference of substance from what is stated in the executive summary. Figure 4.3 also refers to the form and content of financial reports rather than the presentation, scope, and content of financial reports, although there may be no difference of substance here.

We recommend that, as the Initiative moves forward, financial assets are included in the assessment of the suitability of existing international frameworks and that consistent terminology is used.

We would also have expected liabilities to be a priority issue too, for example, funding commitments made by grant-making charities and concessionary loans, spring to mind as two potentially important NPO issues we envisage the NPO Guidance would need to address.

We therefore recommend that consideration is given to including accounting for liabilities as a priority issue for this project.

4.c. Do you agree with the high-level assessment of the existing international frameworks against these criteria? If not, why not? What assessment would you make and why?

In figure 4.3, the assessment that IFRS and the IFRS for SMEs do not provide guidance relevant to accounting for non-financial assets by NPOs is a little harsh. We would see these as providing some guidance relevant to accounting for non-financial assets by NPOs, therefore 'amber' would be a fairer assessment than 'red'.

#### **General matter for comment 5**

5.a. What do you see as the main challenges, if any, with the proposed Guidance model and the use of the IFRS for SMEs Standard as the foundational framework? What, if any, alternative model and/or foundational framework do you suggest would be more suitable and why?

#### **Response to general matter for comment 5**

5.a. We have identified the following main challenges:

- Ensuring that the final Guidance for NPO annual reports and financial statements provides a coherent framework for NPOs as several different, albeit similar frameworks, will be drawn on to produce the Guidance.
- The risk of undue specialisation. We believe that the Guidance should only depart from the IFRS for SMEs where departure is clearly justifiable. (However, see our comments on tiering below).
- Defining the 'reporting entity' could be problematic for users of the Guidance without more specific material on the topic. The consultation paper references the 'reporting entity' but more guidance is needed on identifying the 'reporting entity': this is a fundamental issue for financial reporting. Individual reporting entities can exist within a group structure while still being self-governing for financial reporting purposes. However, NPOs may also have local branches which are

constitutionally part of a parent entity with a national or regional structure and would not be considered to be separate reporting entities for financial reporting purposes.

- Tiering, providing appropriate concessions for smaller or less complex NPOs. We believe that thinking about how tiering at an early stage could be vital in developing Guidance which meets the needs of both accounts preparers and users. This could mean developing core requirements for NPOs which are proportionate and therefore do not require the extensive disclosure requirements which would come with full compliance with the IFRS for SMEs: there could be additional requirements placed on 'larger' entities. In the UK, charities are expected to comply with FRS 102 (see the Annex to our response) which is based on the IFRS for SMEs. FRS 102 permits commercial companies, which meet the definition of small under the UK Companies Act 2006, to take advantage of certain concessions. These concessions are largely disclosure based concessions available under Section 1A of FRS 102 and are not in any practical sense available to charities. As a consequence charity financial statements have increased in length since the implementation of FRS 102 in 2015 and the value of the additional material is not always clear. ICAS, as a participant in the process for reviewing the current Charities SORP (also see the Annex), has contributed ideas on how a tiered approach to charity financial reporting based on Section 1A could work. It is likely that any criteria for accessing concessions made available through a tiered approach would need to be sized-based initially as developing criteria to define a less complex entity is more challenging and work on this is currently being undertaken by the International Auditing and Assurance Standards Board (IAASB) as part of its work on audits of less complex entities. Therefore, instigating a separate project on defining a 'less complex entity' may not be a good use of resources for another organisation.



## Information requested by all participants

**Name:** Christine Scott, Head of Charities and Pensions at ICAS, the Institute of Chartered Accountants of Scotland.

**Email address:** cscott@icas.com.

**Description of the activities of the organisation responding to the consultation:**

ICAS is a professional accountancy body based in the UK. Responding to this consultation on behalf of ICAS is the ICAS Charities Panel. Further information about ICAS is included in the 'Background' section of our response.

**Jurisdiction(s) to which the feedback relates:**

Our feedback primarily relates to our experience of NPO accounting in the UK, mainly charities. Financial reporting requirements for NPOs preparing their financial statements using an accruals-based framework is set at UK level. However, there are sub-UK level differences in respect of legal requirements for NPOs which have a bearing on their financial reporting obligations.

In our response, we have also thought about how accruals-based standards could be applied in jurisdictions where there is currently no NPO financial reporting framework.

**Accounting basis of NPO financial reports in the jurisdiction in which you mainly work:**

Both modified cash and accruals-based, depending on entity size and other criteria, such as company law.

**Financial Reporting Standards used by NPOs in the jurisdiction in which you mainly work:**

Accruals-based requirements for UK NPOs are based on the IFRS for SMEs, adopted and tailored as appropriate by FRS 102: the Financial Reporting Standard applicable in the UK and Republic of Ireland. Further specialist requirements apply over and above FRS 102 and the Public Benefit Entity requirements which are included within its scope.

Receipts and payments financial statements requirements for charities are charity jurisdiction specific but all require charities to disclose assets and liabilities.

There are three statements of recommended practice (SORPs) which apply to the financial statements of NPOs in the UK, where the body is required to prepare financial statements using an accruals-based framework, covering:

- Housing bodies.
- Higher and further educational institutions.
- Charities (which are not housing bodies or education institutions).

SORPs are described as recommended practice but to a large extent compliance with a sector specific SORP is required by law and, where it is not required by law, compliance is considered necessary for financial statements to give a true and fair view.

ICAS is currently involved in the Charities SORP development process: a new process for revising the Charities SORP, which is running alongside the UK Financial Reporting Council's periodic review of FRS 102.

**Please indicate whether you wish to receive further information about this project and consent to being contacted at the email address provided:**

Agreed. The ICAS Charities Panel also agrees that its response to this consultation can be made public.



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