ISSUES PAPER

NOT-FOR-PROFIT FINANCIAL REPORTS AND THE REPORTING ENTITY CONCEPT – WHERE NOW FOR FINANCIAL REPORTING?

BACKGROUND

The Australian not-for-profit (NFP) sector is populated by a diverse group of entities that differ significantly in size, legal form, activities and objectives. The scope of this paper includes charities and other NFPs that are formed as companies limited by guarantee, incorporated associations, trusts, indigenous corporations, cooperatives, unincorporated associations and other entities that have financial reporting obligations. Public sector entities and private sector for-profit entities are not included in the scope of this issues paper.

NFP entities are required to produce annual financial statements for a number of reasons that may include:

- external demands such as compliance with statutory obligations, or meeting the requirements of funding providers
- internal demands such as requirements stipulated in an entity's constitution, or on request by members or the board.

In many instances, financial reporting requirements can include an obligation to prepare financial statements in accordance with Australian Accounting Standards (AAS) issued by the Australian Accounting Standards Board (AASB). Along with the AAS, the reporting entity concept operationalised through the Statement of Accounting Concept 1, *Definition of the Reporting Entity* (SAC 1) is central to the financial reporting framework promulgated by the AASB. It is noteworthy that when a member of one of the three Australian Professional Accounting Bodies (CPA Australia, CAANZ and IPA) is involved in the preparation or the audit/assurance of financial reports, applicable professional and ethical standards require the member to take all reasonable steps to apply the reporting entity concept.

In addition to the overarching requirement that reporting entities should prepare general purpose financial statements (GPFS), the AASB operates a differential accounting standards reporting framework consisting of two tiers of accounting standards (Tier 1: AAS and Tier 2: AAS – Reduced Disclosure Requirements). The AASB requirement that reporting entities prepare GPFS relies on the definitions of reporting entity and GPFS expressed in AASB 1053 *Application of Tiers of Australian Accounting Standards* and the application paragraph in AAS. AASB 1053 contains the following definitions:

- Reporting entity means an entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries.
- GPFS are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

The application paragraphs of all AAS (except AASB s 101, 107, 108, 1031 and 1048) state that the standard applies to:
(a) Each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity;
(b) General purpose financial statements of each other reporting entity; and
(c) Financial statements that are, or are held out to be, general purpose financial statements.
The application paragraphs of AASBs 101, 107, 108, 1031 and 1048 require application of these standards to all entities that are required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act 2001, whether or not they are reporting entities.

When financial statements are prepared in accordance with AAS, a reporting entity is required to prepare GPFS, whilst a non-reporting entity can choose to prepare Special Purpose Financial Statements (SPFS). As described in the previous paragraph, Corporations Act entities are required to apply specific AAS as a minimum. Other legislative frameworks can also impose requirements to apply specific AAS in the preparation of financial statements. Examples include the Australian Charities and Not-for-profits Commission Act 2012 that applies to registered charities, and legislation applicable to incorporated associations in New South Wales.

Companies limited by guarantee regulated by the Australian Securities and Investments Commission (ASIC) may also need to take note of ASIC's position that non-reporting entities, which are required to prepare financial statements in accordance with Chapter 2M.3 of the Corporations Act 2001 should comply with the recognition and measurement requirements of accounting standards. This position is set out in the ASIC Regulator Guide RG 85: *Reporting requirements for non-reporting entities* (RG 85). Incorporated associations in New South Wales categorised as Tier 1 incorporated associations with total annual revenue of less than $2,000,000 are also required to comply with a similar requirement, as set out in Class Order 11/01[1].

Except for stipulated requirements to apply AAS, a non-reporting entity preparing SPFS can generally pick and choose the AAS that it considers are appropriate and relevant to satisfy the financial information needs of the users of its financial statements. As part of its differential reporting project, the AASB issued Reduced Disclosure Requirements (RDR) versions of the AAS in 2010. The AAS RDR introduce a further tier of financial reporting into the differential reporting framework, by allowing all NFPs to apply AAS RDR. The AAS RDR framework of standards, as their title suggests includes significantly reduced disclosure requirements, whilst retaining all the measurement and recognition requirements of the full AAS.

It should be noted that in addition to financial statements prepared by applying AAS, various laws and regulations around Australia can stipulate the form and content of financial reports without any reference to AAS, or with partial reference to AAS. Examples of different types of financial reporting requirements are illustrated in Appendix IV of the CPA Australia publication *Charities: a guide to financial reporting and assurance requirements*[2].

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[1] http://www.fairtrading.nsw.gov.au/pdfs/Cooperatives_and_associations/associations/CO_11_01_Financial_reporting_requirements.pdf
[2] http://www.cpaaustralia.com.au/~/media/corporate/allfiles/document/professional-resources/auditing-assurance/charities-guide-report.pdf

ISSUES WITH THE REPORTING ENTITY CONCEPT

Earlier this year, the AASB released a report[3] setting out findings from a research project it commissioned into the application of the reporting entity concept in the preparation of financial statements by various entities. The report based on empirical research conducted by a group of academics on behalf of the AASB points to a need to change the principles-based regulation proposition that reporting entities should prepare GPFS.

In arriving at the findings, the researchers undertook an analysis of financial statements prepared and lodged by various entities under statutory requirements. These included large proprietary companies and companies limited by guarantee preparing and lodging financial statements with the Australian Securities and Investments Commission (ASIC) (Part A of the report), and incorporated associations, cooperatives and other entities preparing and lodging financial statements with state regulators in Victoria, New South Wales and Queensland (Part B of the report). The research report appears to confirm the opinions of some commentators that the reporting entity concept is not being applied consistently as intended. It should be noted that the impact of AAS RDR (issued in June 2010) on the financial reporting choices made by NFP entities was not considered as part of the research project, as the samples selected for the project were from the period 2008 to 2011.

Part A of the report, which focuses on Corporations Act entities including companies limited by guarantee, identifies widespread use of special purpose financial reporting by lodging entities of various types and sizes, a consequence of their self-determination as non-reporting entities. The findings point to an apparent lack of consistency in the determination by entities of similar size and type as either reporting or non-reporting entities. The research report also notes a wide variation in the stated application of accounting standards by companies. Consequently, the researchers were unable to determine whether the SPFS of non-reporting entity companies comply with the ASIC's RG 85.

Part B of the report, which considers financial statements lodged by NFPs and other entities with state-based regulators, indicates that the majority of lodged financial statements typically did not adopt AAS and were prepared in an inconsistent manner. An analysis of financial statement lodged in Victoria, New South Wales and Queensland reveals great variation in the quantity and quality of information lodged. For a large proportion of entities examined, there was no explicit indication as to whether the financial statements were prepared as GPFS or SPFS. With the exception of larger lodging entities, variations in other lodged financial statements included an absence of balance sheets and/or income statements, with cash flow statements rarely being included. Many entities appear to prepare and lodge cash-based financial statements as opposed to accruals-based financial statements. It should be noted that state-based legislation does not always explicitly require consistent application of AAS (for example, Queensland incorporated associations legislation does not include an explicit requirement to apply AAS in the preparation of financial statements).

The report's conclusions suggest that the regulators need to consider the relevance of the reporting entity concept, or whether it should be changed with the possible creation of more explicit tests via legislation and accounting standards to standardise the application of the reporting entity concept. In addition the report also indicates that the findings may inform discussions among State/Territory lawmakers and regulators in identified areas. Such discussion could involve a re-assessment of user needs for lodged financial information and considering measures that might bring greater consistency across lodged financial statements in various jurisdictions. This could include consideration of which entities should lodge GPFS and for those entities that may have to lodge SPFS, the specific information required for such financial statements.

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[3] http://www.aasb.gov.au/admin/file/content102/c3/AASB_RR-1_06-14_Reporting_Entities_and_SPFSs.pdf

QUESTIONS FOR DISCUSSION

1. Do you agree with the research findings that the reporting entity concept is not being applied as intended? Why, or why not? If it is being misapplied, what are the consequences?

2. Financial reporting obligations arising from legislation and other requirements vary significantly across the NFP sector in Australia. Laws applicable within jurisdictions, entity type, entity activity, entity size are some reasons that give rise to such differences.
   a. Are there valid reasons for differences in financial reporting requirements by different NFPs? Why, or why not?
   b. Is there scope for categorising different NFPs by size/type etc. and bringing consistency to financial reporting requirements for different categories of NFPs across Australia? (For example, is it possible to consider all incorporated associations across Australia as belonging to one category, and develop consistent financial reporting requirements for them?) If yes, please provide your suggestions on arriving at different categories based on size, type, activities and objectives, and how financial reporting consistency could be achieved within such categories.

3. What in your view are the primary drivers of financial reporting by NFPs? In your reasoning, please consider
   a. the objectives of NFP financial reporting including the information needs of stakeholders
   b. whether some NFPs should be totally exempted from financial reporting, and what criteria should be considered in determining any such exemptions.

4. In your view, does the AAS RDR framework provide an appropriate financial reporting framework for NFPs that are required to prepare financial reports under AAS? If not, what other options should be explored by the AASB as appropriate framework(s) for financial reporting by NFPs?

5. Some statutory and other financial reporting requirements do not state that financial statements should be prepared in accordance with AAS (for example, incorporated associations legislation in Queensland and Tasmania). Is it appropriate for statutory and other financial reporting requirements for NFPs to continue to make no specific reference to AAS? If yes, please state your reasons? If no, what other options should be considered?

6. In addition to annual financial reporting requirements, NFPs are often required to provide other information, such as grant acquittals and project specific financial information to funders etc. (For example, an NFP that has received multiple grants could be required to provide periodic grant acquittals for each of the grants received). Is there scope for simplifying these additional financial reporting obligations that NFPs have to comply with?

7. It is held that the information needs of NFP stakeholders go beyond financial information. For example, the AASB is currently involved in a project to develop a standard for service performance reporting by NFPs. In your view, what other information should a NFP provide to its stakeholders? Also, who should develop the relevant frameworks and/or requirements for such reporting?

8. Do you have any other issues that you would like to raise? For example, the interaction of the reporting entity concept and the requirement to prepare general purpose financial statements by for-profit entities with financial reporting obligations under the Corporations Act 2001, or the interaction of the reporting entity concept with financial reporting by public sector entities.