

The Application of International Accounting Standards in the Financial Statements of Tearfund Partners

Context:

International Accounting Standards (IAS) have been developed primarily to bring consistency into the financial reporting of commercial organisations so that investors and investment analysts can compare one organisation’s financial results with another. They provide assurance that the same accounting methods and principles have been applied in the production of financial information, and that all important information has been disclosed.

The application of International Accounting Standards is not a legal requirement but auditors are expected to report on any non-compliance as the Standards are considered the best guide as to what represents a ‘True and Fair View’.

The world of NGOs is significantly different to that of commerce and a number of the Standards are either inapplicable to NGO’s or their application may be seen as being of little value in terms of the extra work involved and information disclosed. However, many of them address fundamental accounting concepts and practices which would be expected in any organisation attempting to produce ‘True and Fair’ Financial Statements and so they should be consistently applied.

A summary of the Standards that are likely to have relevance to the financial statements of Partners, and the way they should be applied, is set out below. Partners are expected to take note of these matters in their annual Financial Statements in order to fulfil the terms of the Grant Agreement and should ensure that their Auditors are made aware of the contents of this document.

IAS	<i>Relevant standards and interpretations for NGOs</i>
1	<p>Overall considerations for Financial Statements The statement describes the basic content of Financial Statements and the fundamental principles of accounting.</p> <p>Financial Statements should include:</p> <ul style="list-style-type: none"> • Balance sheet • Income statement – the standard requires the separation of operating and non-operating activities and specifies the key figures to disclose in the statement. This is to ensure a clear explanation of the level of profit generated by the main operational activity of the organisation as distinct from any other type of investment or donated income. <i>In NGOs it is helpful to separate the activities of externally funded projects from the ‘core’ activity of managing the organisation. Each funded project should have a neutral effect on the Income Statement (ie. neither surplus nor deficit) and the total income and costs of these projects may fluctuate significantly from year to year. Donors are interested to see the sources and level of income generated for funding the core management of the organisation, as well as the types of expenditure that are covered, as this gives a guide as to the sustainability of the organisation and helps to justify the level of administration charges made against projects. Partners who have commercial income generating projects should also disclose these results separately.</i> • Cash flow statement (IAS 7: Cash Flow Statements sets out the details)

	<p><i>NGO's do not normally show a significant surplus or deficit but cash and bank balances may fluctuate greatly at the year end due to the timing of grants received. It is helpful to reconcile the difference in a cash flow statement, although small NGO's with very simple Balance Sheets may not gain much from the exercise.</i></p> <ul style="list-style-type: none"> • Statement showing changes in Equity ie. an explanation of why the balances on shareholders capital and reserves have changed. <i>In the case of NGOs this should be a statement showing the changes in Accumulated Funds. Restricted and Unrestricted Reserves. Many NGOs maintain reserves for staff benefits, fixed asset replacements or repairs as well as unrestricted reserves deriving from surpluses generated. They may also hold restricted reserves when donors have sent money in advance for specific purposes. It is helpful to clearly explain the movement on all these different funds.</i> • Notes giving further information about the organisation's financial affairs and details of important figures in the Balance Sheet and Income and Expenditure Account <p>The following principles should be followed in compiling the financial statements:</p> <ul style="list-style-type: none"> • Fair presentation – <i>ensure that the presentation of factual information represents the reality of the organisation's situation – eg. A debt shown in the balance Sheet may be real and numerically correct, but is it ever going to be recovered?</i> • Accounting policies – <i>explain the accounting methods chosen for items such as depreciation, asset valuation, foreign exchange conversion, recognition of income</i> • Going concern – <i>assets are valued on the basis that the organisation can continue its activities for the foreseeable future</i> • Accrual basis of accounting – <i>apply income and expenditure to the period when they were incurred, rather than when they were paid. NGO's especially need to apply the accrual concept to grant income.</i> • Consistency of presentation – <i>apply accounting policies consistently from one year to the next so that results are comparable</i> • Materiality and aggregation – <i>ensure that significant items are shown separately but avoid unnecessary detail</i> • Offsetting – <i>ensure that sufficient detail is shown in the financial statements where opposite types of transaction are passed through the same account and are deducted from each other (eg. the balance on a loan is made up of the initial advance, plus interest, less repayments. It may be relevant to disclose all the components)</i> <p><i>Comparative information – it is helpful to show the preceding year's figures alongside the current year, in all financial statements, so that changes from one year to the next can be clearly seen. This helps to ensure consistent accounting treatment.</i></p>
2	<p>Inventories</p> <ul style="list-style-type: none"> • Inventories should be measured at the lower of cost and net realisable value. Net realisable value is selling price less cost to complete the inventory and sell it. • Cost includes all costs to bring the inventories to their present condition and location. <i>NGO's sometimes have a limited market for goods produced and often carry more inventory than they can realistically hope to sell. Net realisable value should be applied in terms of price and quantity in</i>

	<i>these cases.</i>
8	<p>Exceptional items, Changes of accounting policy and Prior Year adjustments</p> <ul style="list-style-type: none"> • Separate disclosure of extraordinary items of profit or loss is required on the face of the income statement, after the total of profit or loss from ordinary activities. Such extraordinary items are rare and beyond management control. • Items of income or expense arising from ordinary activities that are abnormal because of their size, nature or incidence are separately disclosed, usually in the notes. • Prior year adjustments normally relate to the correction of major errors in previous accounts or significant changes in accounting policy. The adjustment is shown separately as a change to the balance brought forward on reserves. <p><i>These items are not common and the important point is to show separately items that would otherwise distort the reporting of the normal income and expenditure.</i></p>
10	<p>Post Balance Sheet events</p> <ul style="list-style-type: none"> • an enterprise should adjust its financial statements for events after the balance sheet date that provide further evidence of conditions that existed at the balance sheet date; <p><i>The strict application of this standard may be limited for NGOs but the principle of reviewing the value of assets and liabilities in the Balance Sheet in the light of circumstances that occur after the end of the year is highly applicable. EG: the reduction in value of debts and inventories where full recovery is in doubt.</i></p>
14	<p>Segmented reporting</p> <p><i>The strict application of this standard is unlikely to be relevant to smaller NGOs but the principle of reporting clearly on different types of activities or different geographical locations is highly applicable. For example this might involve the disclosure of the results on individual projects, a distinction between development work and relief work, or between externally funded work and commercially sustainable activities. The aim is to bring clarity on which activities are in surplus or deficit and to attribute certain assets and liabilities to different activities.</i></p>
16	<p>Fixed Assets</p> <ul style="list-style-type: none"> • Property, plant and equipment should be recognised when <ul style="list-style-type: none"> a. it is probable that future benefits will flow from it, and b. its cost can be measured reliably. • Initial measurement should be at cost. <p>Depreciation:</p> <ul style="list-style-type: none"> • Long-lived assets other than land are depreciated on a systematic basis over their useful lives. • Gains or losses on retirement or disposal of an asset should be calculated by reference to the carrying amount. • Required disclosures include: <ul style="list-style-type: none"> ○ Reconciliation of movements on fixed assets ○ Capital commitments. ○ Items pledged as security.

	<ul style="list-style-type: none"> ○ Depreciation methods and rates
18	<p>Revenue</p> <ul style="list-style-type: none"> • Revenue should be measured at fair value of consideration received or receivable. Usually this is the inflow of cash. <i>Gifts or contributions in kind may also be valued</i> • Revenue should be recognised when: <ul style="list-style-type: none"> ○ significant risks and rewards of ownership are transferred to the buyer; ○ managerial involvement and control have passed; ○ the amount of revenue can be measured reliably; ○ it is probable that economic benefits will flow to the enterprise; <i>This may help to guide NGO's that receive gifts in kind, legacies etc. or the promise of such gifts</i> • Revenues and related expenses must be matched. If future related expenses cannot be measured reliably, revenue recognition should be deferred. <i>For NGO's this applies significantly to project grants. Grants should not be treated as income until they have been used to meet the related expenses. If a grant has not been fully used at the Balance Sheet date the unused portion should be accrued as a liability or held as a restricted fund.</i> • Required disclosures include: <ul style="list-style-type: none"> ○ Revenue recognition accounting policies. <i>eg. the treatment of grants</i> ○ Amount of each significant category of revenue recognised. ○ Amount of revenue from exchanges of goods or services. <i>See also the Standard 14 on Segmented Reporting</i>
20	<p>Government Grants</p> <ul style="list-style-type: none"> • Grants should not be credited directly to equity. They should be recognised as income in a way that is matched with the related costs. <i>See also the note on Standard 18 – this applies to all grants from major donors</i> • Grants related to assets should be deducted from the cost or treated as deferred income. <i>There is often confusion in NGOs as to whether fixed assets purchased using a donors' grant should be shown in the Balance Sheet. The asset has a long term value but the donor may want to see the purchase recorded as a project expense. It is suggested that in these cases the asset is originally recorded as a project expense and written off when purchased – it is deemed to belong to the donor, even if legally owned by the NGO. When the project is completed the donor may allow the NGO to keep the asset. At this point the current value of the asset can be treated as a gift in kind from the donor and the asset can be capitalised and depreciated in the usual way.</i>
21	<p>Changes in Foreign Exchange Rates</p> <p><i>Transactions should be converted at the rate ruling on the date of the transaction. In practice limitations of the accounting system will often mean that Income and Expenditure will be converted using the average rate for the accounting period.</i></p> <p><i>Balance Sheet items should be converted using the closing rate on the Balance Sheet date.</i></p> <p><i>Any surplus or deficit arising on conversion should be reflected in the Income</i></p>

	<i>and Expenditure Statement</i>
24	<p>Related Party Transactions</p> <ul style="list-style-type: none"> • Related parties are those able to control or exercise significant influence. Such relationships include: <ul style="list-style-type: none"> ○ Entities under common control. ○ Individuals who, through ownership, have significant influence over the enterprise and close members of their families. ○ Key management personnel. <i>For NGOs this would include Board Members, senior executives, members of their families or other businesses under their influence</i> • The nature and amount of transactions with related parties should be disclosed
37	<p>Provisions and Contingencies</p> <p><i>A provision should be made for liabilities that the organisation knows it will have to meet at some time but which it cannot quantify at present. Examples might include certain staff benefit funds or maintenance commitments on a rented property.</i></p> <p><i>Contingencies are events that could occur in the future but where there is no certainty. In these cases no adjustment is made to the Financial Statements but a note of explanation should be given. Eg. a legal case may be in process for or against the organisation</i></p>