

2. FRAMEWORK

2.1 Users and their Information Needs as applied to NPOs

EXTERNAL USERS

- a. Donors/Grantors/Funding Agencies
 - Degree of attainment of development objectives as indicated in financial statements and reports.
 - Degree of compliance with agreed amount and manner of using funds.
 - Degree of compliance with prescribed financial accounting and reporting system and procedures
- b. Creditors (Banks/Financing Institutions)
 - Information on ability to pay as indicated by ratios of solvency, liquidity, and stability as well as status of their security.
- c. Government Agencies
 - Compliance with laws, government rules and regulations, payment of taxes (if any) and reportorial requirements
- d. General Public
 - Effect of the activities of NPOs to the community and society in general

INTERNAL USERS

- e. Members
 - Information on how fees, donations, grants, and proceeds from fundraising activities were used.
 - Other information needs such as managerial remuneration, use of assets, management efficiency, etc.
- f. Management Team
 - Board of directors/trustees for policy-making, strategic decision-making, and fulfilling its trusteeship/stewardship role.

- Executive Director for operational decision-making
- Program/project managers for project/program-related decision making

2.2 Objectives of Financial Reporting

The primary objective of financial reporting by NPOs is to provide information about the financial position, performance, and cash flows of the organization that is useful, and indeed, necessary, for a wide range of users to engage in informed decision making.

Financial reporting prepared for this purpose meets the common needs of most users. However, financial reporting does not provide all the information that users may need to make decisions since they mostly portray the financial effects of past events.

Financial reporting also shows the results of the stewardship of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make sound decisions. The financial reports of NPOs should compliment other non-financial, performance reports.

The financial reporting is the means by which the information gathered and presented in financial accounting is regularly communicated to those who use it.

2.3 Basis of Accounting

Description

The basis of accounting affects the timing of recognition of income and expenses. When a cash basis of accounting is used, income is recognized once it is received while expense is recognized once it is paid. On the other hand, using an accrual basis means that income is recognized when it is earned, even when it has not yet been received, and expenses are recognized when they are incurred even when they have not yet actually been paid.

Basis of Accounting	Recognition of Income	Recognition of Expense
Cash Basis	When cash is actually received	When cash is actually paid
Accrual Basis	When income is earned pertaining to the period	When an expense is incurred pertaining to the period even when not yet actually paid

The basis of accounting used, as discussed and summarized above, affects the presentation of the financial statements of the organization.

In cash basis, a transaction is recorded only when actual cash has been received or spent. Basically, only the movement of cash can constitute a transaction. Under this basis of accounting, funds are recognized as receipts for the period if these are actually

received within the current year. Expenses actually paid for in the current year are recognized for the period. This is regardless of whether the receipts or expenses pertain only to the current year, prior to or beyond it. This may result in an over/understatement of the net asset that make up a specific period.

In accrual basis, revenues and related assets are recognized when earned rather than when received while expenses are recognized when incurred rather than when paid. There is recognition of receivables and payables built up within a specific period.

The Recommended Basis of Accounting for NPOs

After extensive deliberations in the consultations and conferences, it was decided that the Accrual Basis should be adopted by NPOs as this basis is considered to be more accurate aside from the preferred basis of the respective national accounting standards-setting bodies. The use of the accrual basis of accounting helps present more fairly and accurately the financial status of NPOs. It was also seen to be required if an organization wanted to measure the cost of a project or activity or when comparative statements are required to be prepared. It was also pointed out that the accrual basis of accounting facilitates the use of the budget as part of control techniques.

(A separate discussion and illustration of the application of Accrual Basis to NPOs is presented in Chapter 5)

An option for small NPOs (where there is an insignificant difference between cash and accrual bases), is to combine the simplicity of the cash basis and the accuracy of the accrual basis, i.e., cash basis in the interim and accrue transactions that need to be accrued when preparing periodic general-purpose financial reports. Thus, the financial reports are still presented in accrual form. The accounting standards setting body of each country has to define the qualifications of small NPOs.

Donor-specific financial reports, being specific-purpose financial reports, may be presented using the cash basis upon the agreement between the NPO and the donor. As in the case of other specific-purpose reports, reconciliation between the specific reports prepared in cash basis and the general-purpose reports prepared in accrual basis, is necessary when required.

Exemption

In some countries, cash basis of accounting is allowed or required by local laws for NPOs. In such cases, NPOs may use the cash basis.

2.4 Assumption of Going-Concern

The financial statements are normally prepared on the assumption that an NPO is a going concern, and will continue to be in operation for the foreseeable future. It is thus assumed that the NPO has neither the intention nor the need to liquidate or

scale back its operations; if such an intention or need exists, the financial statements may have to be prepared using a different basis, in which case, this basis should be disclosed.

There are instances where an NPO is established *ad hoc* or its existence is limited to a specific period. In this case, the management of an *ad hoc* NPO should properly disclose its nature and terms of existence, as well as the implications of its *ad hoc* nature on its financial statements.

2.5 Qualitative Characteristics of Financial Statements

These are the attributes that make the information in financial statements useful to various NPO stakeholders, who are the users of the information. An essential quality of the information provided is its understandability by users.

- a. **Relevance.** Information has the quality of relevance when it influences the decisions of users by helping them evaluate past, present or future events or confirming, or correcting their past evaluations.
 1. **Materiality.** Information is material if its omission or misstatement could influence the decision of users taken on the basis of the financial statements.
 2. **Timeliness.** Accounting information must be available on time when needed if it is to influence decisions. Lack of timeliness reduces relevance.
- b. **Reliability.** Information is reliable when it is free from material error and bias and can be depended upon by users to embody faithfully the representation contained therein.
 1. **Faithful Representation.** To be reliable, information must represent faithfully the transactions and other events that it either purports to represent or could reasonably be expected to represent.
 2. **Substance over form.** Transactions and other events are accounted for and presented in accordance with their substance and not merely their legal form.
 3. **Neutrality.** Information must be free from bias. Financial statements are not neutral if, by selection or presentation of information, they influence the making of a decision or judgment in order to achieve a predetermined result or outcome.
 4. **Prudence.** Some degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or revenues are not overstated and liabilities or expenses are not understated.
 5. **Completeness.** Information must be complete within the bounds of materiality. Omission may cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.
- c. **Comparability.** Users must be able to compare the financial statements through time in order to identify trends in its financial position and performance.

- d. **Understandability.** An essential quality of the information provided in financial statements is that it is readily understandable by users.

Balance between Qualitative Characteristics

In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally, the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

Fair Presentation

Financial statements are frequently described as a fair presentation of an organization's financial position, performance, and changes in financial position. Although this framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as presenting fairly such information.

2.6 Accounting Elements

Financial Position. The elements directly related to the measurement of financial position are an organization's assets, liabilities, and equity.

- a. Asset is a resource controlled by the organization as a result of past transactions or events and from which future economic benefits or service potential are expected to flow to the organization.
- b. Liability is a present obligation of the organization arising from past transactions or events, the settlement of which is expected to result in an outflow of resources from the organization embodying economic benefits or service potential.
- c. Equity is the residual interest in the assets after deducting all its liabilities. In business enterprises, equity represents the net ownership of the enterprise.

NPOs do not have specific owners, thus the remaining value of its assets does not go to its members. Assets and their residual values are intended for specific purposes; therefore, it is not appropriate to use the term "equity" in reference to NPOs.

In place of "equity", NPOs use the term "**Net Assets**" to emphasize the outstanding value in the statement of financial position (assets less liabilities).

The US GAAP,³ Chinese GAAP and IPSAS⁴ use "Net Assets;" however, IPSAS 1.6 also states that "other terms may be used in place of net assets/equity, provided

³ GAAP = Generally Accepted Accounting Principles

⁴ IPSAS = International Public Sector Accounting Standards

that their meaning is clear”. In this regard, the respective national accounting standards-setting body may define the appropriate term in the specific country. Many NPOs prefer to use the term “fund balance” to describe the balance of a fund, defined as a sum set aside for specific purpose, as of any given date.

Performance. The elements directly related to measurement of financial performance are revenue and expenses.

- d. Revenue is the total inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in Net Assets.
- e. Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumptions of assets or incurrence of liabilities that result in decreases in Net Assets.

2.7 Recognition and Measurement

Recognition is the process of incorporating in the financial statements an item that meets the definition of an element. An item that meets the definition of an element should be recognized if:

- a. It is probable that any future economic benefit or service potential associated with the item will flow to or from the organization;
- b. The item has a cost or value that can be measured with reliability.

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the financial statements. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements:

- a. **Historical cost.** Pertains the original cost of an asset to an entity.
- b. **Fair value.** The amount for which an asset may be exchanged or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.
- c. **Replacement cost.** The amount it will cost to replace an asset at current prices.
- d. **Net realizable value.** This refers to the net monetary gain of a transaction, i.e., the selling price of an asset less expenses.
- e. **Value-in-use.** Represents the market value of an asset that reflects a value to a particular user, recognizing the extent to which the property contributes to that entity.