Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Not-for-Profit Private Sector Financial Reporting Framework**	**Meeting:**	M179
Topic:	**Applicability of the different tiers to not-for-profit private sector entities**	**Agenda Item:**	5.3
		Date:	10 February 2021
Contact(s):	Evelyn Ling eling@aasb.gov.au Ao Li ali@aasb.gov.au Fridrich Housa fhousa@aasb.gov.au	**Project Priority:**	High
		Decision-Making:	High
		Project Status:	Decide scope of consultation document and key aspects of possible differential reporting framework

OBJECTIVE OF THIS PAPER

1 The objective of this staff paper is for the Board to **form a preliminary view** for inclusion in a discussion paper on (1) whether it should specify the minimum reporting Tier a not-for-profit (NFP) private sector entity must comply with, and if so, (2) the nature of the criteria that should be used to determine the applicability of the different tiers to not-for-profit private sector entities.

BACKGROUND AND REASONS FOR BRINGING THIS PAPER TO THE BOARD

2 At its 11-12 November 2020 meeting, the Board decided to progress with its project on developing a revised financial reporting framework for Australian NFP private sector entities. The Board decided that it would issue, as a first step, a consultation document to expose its preliminary proposals for that framework. Agenda Paper 5.2 discussed possible reporting Tiers that might be included in a differential reporting framework for NFP private sector entities. For the purposes of the future consultation document, to the extent multiple reporting Tiers are developed, the Board will need to consider whether the Australian Accounting Standards should stratify entities into the different available reporting Tiers, and if so, the criteria for stratification.

WHETHER THE BOARD SHOULD SPECIFY THE ENTITIES IN EACH REPORTING TIER

3 Independent of its decision to specify different possible Tiers of general purpose financial statements, the Board will need to decide whether it should specify in Australian Accounting Standards a minimum Tier of general purpose financial statements that must be prepared by a NFP private sector entity. This decision is necessary even if the Board decides not to add any further reporting Tiers as in that case, the Board will need to form a preliminary view for the purposes of the discussion paper whether it should maintain the status quo (specifying that NFP private sector entities should comply with Tier 2 reporting requirements at a minimum) or change it.

4 The Board could take one of the following actions:

(a) Option 1: Not specify a minimum reporting Tier that a NFP private sector must comply with, if it is preparing financial statements that are held out to be general purpose financial statements. Under this option, the determination of which reporting Tier (Tier 1/ Tier 2 and any further reporting Tiers agreed per Agenda Paper 5.2) satisfies the entity's reporting obligations is left to the entity or compliance to a specific reporting Tier specified by the responsible regulatory body/respective legislation or constituting document.

(b) Option 2: Specify a default reporting Tier for all NFP private sector entities preparing financial statements that comply with Australian Accounting Standards; permitting entities to comply with a lower level reporting Tier only as permitted by a regulatory body (or by their constitution or other document, if that is the reason the general purpose financial statements are prepared); or

(c) Option 3: Specify a minimum reporting Tier that a NFP private sector must comply with, if it is preparing financial statements that are held out to be general purpose financial statements.

5 Option 1 and Option 2 largely put the onus on the regulator and respective legislation, or members and those charged with governance, to identify the extent of reporting required, rather than the AASB. These options reflect the view that the body requiring the preparation of financial statements should be the body specifying the extent of information required. To the extent duplicated financial reporting obligations have not yet been reduced where a NFP private sector entity has reporting obligations to more than one regulatory body (e.g. the ACNC and the Queensland Office of Fair Trading[1]), these options could arguably add another layer of reporting complexity for the entity.

6 Option 1 is not consistent with the approach the Board has taken with respect to for-profit private sector entities, i.e. specifying that the general purpose financial statements of publicly accountable for-profit private sector entities must comply with Tier 1 reporting requirements and those of other for-profit private sector entities to comply with, at a minimum, Tier 2 reporting requirements. In addition, to the extent a reporting Tier is not specified by the responsible regulatory body, Option 1 may not sufficiently address the existing concern that an entity may not be reporting appropriate or adequate information in its (special purpose) financial statements. Option 1 will also likely require a change to legislation to effect, which would take time.

7 Option 2 addresses the existing concern that an entity may not be reporting appropriate or adequate information in its financial statements, by setting a higher default bar and requiring a body other than the entity to make the determination as to whether reporting relief is appropriate. However, Option 2 creates additional red tape, as entities may be required to apply to the regulator for reporting relief to the extent such relief is not required to be effected through a change to legislation. Also, the result may be such that 'similar' entities have different reporting requirements (either within, or across, jurisdictions), reducing the comparability of the financial statements those entities prepare. Regular review of the relief may be required, necessitating further maintenance costs.

8 Option 3 is consistent with the approach the Board has taken to date in AASB 1053 *Application of* Tiers *of Australian Accounting Standards*, whereby the Board has specified the minimum reporting Tier compliance of each type of entity. General purpose financial statements are

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1 A reduction in the duplicated annual reporting between the ACNC and OFT is expected to be finalised in 2021 (https://www.qld.gov.au/law/laws-regulated-industries-and-accountability/queensland-laws-and-regulations/associations-charities-and-non-for-profits/incorporated-associations/new-laws)

meant to provide information that is useful to primary users of the financial statements and the Board is responsible for identifying ‘useful information’; as the differential information needs of the users of different types of entities is relevant to identifying useful information in each reporting Tier, it appears reasonable for the Board to also then identify which entities it intends the reporting requirements of a particular Tier to apply to.

9 Staff agree with the premise that the regulator or respective legislation rather than the accounting standard-setter should ideally specify the financial reporting requirements if they require entities to prepare general purpose financial statements (i.e. satisfying the needs of primary users) in accordance with Australian Accounting Standards, in much the same way as these bodies specify whether an audit or a review (or neither) of those financial statements are required. However, staff is conscious that neither Option 1 nor Option 2 will at this time reduce reporting complexity for NFP private sector entities. Consequently, staff support Option 3.

Question for Board members

Question 1	Do Board members support for the purposes of the future consultation document the proposal that the Australian Accounting Standards should specify a minimum reporting Tier that a NFP private sector must comply with, if it is preparing financial statements that are held out to be general purpose financial statements (i.e. Option 3)?

10 The remainder of this paper is relevant only if the Board supports Option 3 (or possibly, a form thereof). If the Board supports Option 2, staff will bring a proposal for identification of a default reporting Tier for Board consideration to a future meeting.

STAFF ANALYSIS OF THE POSSIBLE CRITERIA TO CATEGORISE NFP PRIVATE SECTOR ENTITIES INTO EACH REPORTING TIER

11 Assuming the Board supports Option 3 above, at this meeting, staff are only seeking direction from the Board as to whether the identification of entities in each proposed Tier should ideally have as its defining characteristic (1) qualitative criteria or/and be based on (2) one or more quantitative thresholds. This will allow staff to better focus efforts when developing possible Tier scoping to be included in the future consultation document for the Board’s consideration at a future meeting. Staff note that alternatively, the Board could elect to adopt an approach similar to that taken by the UK Financial Reporting Council in UK Financial Reporting Standard FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. These pronouncements specify the type of entity the Standard applies to (e.g. ‘small entity’), leaving determination of the threshold to qualify as that type of entity to be addressed outside the accounting standards. Staff do not support this approach and have not included it as an option in this paper. This is primarily because the reporting obligations of Australian NFP private sector entities are specified by multiple bodies which do not necessarily adopt a consistent approach to stratifying entities (e.g. Fair Trading NSW stratifies incorporated associations into ‘Tier 1’ (larger) and ‘Tier 2’ while Consumer Affairs Victoria categorises incorporated associations as ‘Tier 1’ (smallest), ‘Tier 2’ and ‘Tier 3’).

12 Staff also think that, in the main, a stratification that is based on the nature of the entity (e.g. by specifying the reporting Tier that a member-based sporting club or a charity that operates in the aged care sector must comply with) would not appear to achieve the Board’s objective of developing a differential framework that is proportionate to the entity’s status, as it does

not acknowledge disparity in entity size or significance. Staff think that a differential framework that is 'proportionate' can only be achieved if entities are differentiated based on qualitative or quantitative criteria.

13 Set out in the paragraphs below for the Board's consideration are reasons supporting or against developing criteria based on qualitative or quantitative factors.

Qualitative criteria

14 Staff have identified the following as reasons supporting using qualitative thresholds to delineate the entities that would fall into each reporting Tier:

- qualitative thresholds can be objective; for example, whether an entity has deductible gift recipient status or the scale of its operations and geographical coverage;
- provides entities with a principle, rather than a rule, for identifying the applicable reporting Tier;
- transitioning between reporting Tiers is less likely to occur compared to use of a quantitative threshold;
- no need to continually review appropriateness of the threshold (excepting the post-implementation review process and subject to stakeholders raising an issue with the Board);
- maintains consistency with the nature of the threshold currently used to differentiate whether for-profit entities should comply with Tier 1 or Tier 2 reporting requirements ('publicly accountable'); and
- similar criteria may be relevant for use for distinguishing reporting by public sector entities.

15 Staff have identified the following as reasons <u>against</u> using qualitative thresholds to delineate the entities that would fall into each reporting Tier:

- qualitative thresholds that require some extent of self-assessment are more subjective than quantitative thresholds. This was the cause of questionable diversity in the application of the SAC 1 reporting entity concept, which in part this Board project is seeking to redress. Accordingly, qualitative thresholds could be seen as being less consistent with the project objective of developing a financial reporting framework that is 'simple, consistent and transparent'; and
- identifying suitable qualitative thresholds that are easily applied by entities is likely to be challenging, especially as a different qualitative threshold will need to be identified for each reporting Tier and as an entity should meet the criteria for only one threshold. Staff note that when developing AASB 1053, the Board at that time concluded that a modified definition of public accountability in the NFP private sector context would not provide a robust basis for identifying entities falling under different reporting Tiers given complexities involved (including some of those listed above) and since many such entities would be regarded as 'publicly accountable' in the general sense of the term (AASB 1053.BC42-BC45). Similarly, in AASB Discussion Paper *Improving Financial Reporting for Australian Charities* quantitative thresholds were proposed as proxies to represent different extents of qualitative features such as 'public interest' and 'economic significance'.

16 Staff could look to identify more objective qualitative criteria that arguably proxy the extent of more subjective criteria, or to expressing the thresholds as a set of qualitative conditions that

must be met, similar to how various Australian Accounting Standards already require specified criteria to be met before certain accounting (or accounting relief) can be achieved. For example, the Board could require an entity that obtains most of its operating funding from a large number of unique donors, and operates nationally, to prepare general purpose financial statements that comply with a certain reporting Tier. Failure to meet both conditions could result in the entity being permitted to prepare general purpose financial statements that comply with a lower reporting Tier.

Quantitative (size) thresholds

17 Staff have identified the following as reasons supporting using size thresholds to delineate the entities that would fall into each reporting Tier:

- quantitative thresholds are usually viewed as more objective compared to qualitative thresholds, and may be easier to calculate. This is consistent with the project objectives of 'simplicity', 'consistency' and 'transparency' as the corresponding Tier can be clearly identified by all parties;
- in the main, Australian NFP regulatory bodies, including the ACNC, use size thresholds to differentiate reporting obligations[2]; the similar use by the AASB of size thresholds could align the degree of financial reporting to the degree of 'importance' of the entity suggested by the regulator's categorisation of entities under its responsibility. For familiarity reasons, quantitative thresholds may be more quickly accepted compared to qualitative thresholds;
- consistency with international practice. The categorisation of New Zealand NFP public benefit entities (PBE) other than Tier 1 entities includes meeting a quantitative threshold. Similarly, UK FRS 105 indirectly require a quantitative threshold to be met for access to simpler reporting requirements;[3]
- may be easier to develop than workable qualitative thresholds. In AASB Discussion Paper *Improving Financial Reporting for Australian Charities* measures such as expenses or revenues (e.g. donations or government funding) were contemplated as proxies to signal the extent of public interest, economic significance, or external users of the financial statements. Similarly, the thresholds for defining a proprietary company as large or small in the *Corporations Act 2001* are set to capture economically significant entities; the Explanatory Statement accompanying *Corporations Amendment (Proprietary Company Thresholds) Regulations 2019* notes that the larger the size of the company, the more likely it is that there will exist users dependent on general purpose financial statements as a basis for making economic decisions.[4] Staff note that more recently, the targeted outreach conducted by staff in August – October 2020 discussed revenue as a discrimination criteria – while stakeholders shared concerns about revenue as a sole reporting tier determination, staff did not receive feedback objecting to the use of quantitative criteria itself; and
- one of the goals of the trans-Tasman Single Economic Market agenda is for private NFP entities to be able to use a single set of accounting standards and be required to prepare only one set of financial statements.[5] While the *Protocol For Co-Operation Between: The Australian Accounting Standards Board, The Australian Auditing And Assurance Standards*

2 AASB Research Report No.5 *Financial Reporting Requirements Applicable to Charities* (October 2017)
3 AASB Staff Paper: Comparison of Standards for Smaller Entities (April 2018)
4 Explanatory Statement to Corporations Amendment (Proprietary Company Thresholds) Regulations 2019
5 Memorandum of Understanding Between the Government of New Zealand and the Government of Australia on the Coordination of Business Law (updated 2013)

Board, The Australian Financial Reporting Council, and The New Zealand External Reporting Board anticipates that this might not be possible given that Australian Accounting Standards for NFP private sector entities are based on IFRSs while those relevant to similar New Zealand entities are based on IPSASs, adopting thresholds (or approach to their determination) that are consistent or analogous with the size thresholds used to establish the differential reporting requirements of NZ NFP entities may move Australia slightly closer towards achieving this goal.

18 Staff have identified the following as reasons <u>against</u> using size thresholds to delineate the entities that would fall into each reporting Tier:

- a size threshold is arbitrary, and it will be difficult to specify national thresholds that appropriately matches varying levels of economic, social, and political significance across different Australian NFP private sector entities. For example, a 'small' entity in New South Wales may be regarded as relatively quantitatively 'large' in another State or Territory. Accordingly, a size threshold would arguably not be consistent with the 'consistent' objective of the Board's project;
- size thresholds will require additional maintenance and monitoring costs to maintain relevance of the quantitative threshold. For example, a size threshold based on assets may have required reviewing if the implementation of AASB 16 *Leases* was expected to result in the recognition of additional assets. In addition, the Board would need to make decisions about whether to revise size thresholds maintained in Accounting Standards to the extent 'matched' legislated thresholds are not similarly regularly subject to review.
- the achievement of a size threshold that is based on revenues or expenses is subject to volatility, possibly driven by factors outside the entity's control; for example, the Covid-19 pandemic may have resulted in changes that may not fairly reflect the continued public interest (or similar) of the entity;
- there may be more instances of transitioning between reporting Tiers if a quantitative threshold were applied. This may be less desirable to facilitating consistency and comparability in reporting by entities. However, one of the ways this could be managed is by requiring the quantum to be calculated as a rolling average across several periods or requiring a combination of two or more quantitative criteria to be met, similar to how proprietary companies are categorised as large or small based on meeting at least two of the three size criteria;
- to the extent the quantitative threshold relates to a consolidated entity position, this may introduce further complexity for entities, as the entity may be tasked with establishing consolidated assets or expenses or revenues;
- there may be incentive to make business decisions that achieve a certain reporting outcome; and
- a quantitative threshold would be a rule, rather than a principle.

19 When making AASB 1053, the Board proposed requiring NFP entities that met certain size thresholds to be subject to Tier 1 reporting requirements. The Board subsequently decided not to proceed with such proposals after considering constituent feedback on the issue, noting the complexities involved and on concluding that the disadvantages of using size thresholds would exceed any advantages that may arise from their use (AASB 1053.BC47-BC51, BC33-BC34). However, feedback from the targeted outreach conducted by staff in August – October 2020 indicates some support (at least in relation to stratifying smaller NFP private sector entities) for using quantitative thresholds to differentiate the extent of reporting requirements

that should apply. In part, the support has its premise in such thresholds maintaining consistency with the familiar use of such thresholds already imposed by regulatory bodies.

A mix of qualitative and quantitative criteria

20 A further possible manner of categorising NFP private sector entities into the reporting Tiers is to categorise entities into each reporting Tier by reference to a mix of qualitative and quantitative thresholds. This could be actioned either as:

(a) the entity meeting both specified qualitative **and** quantitative criteria; or

(b) the entity meeting either specified qualitative criteria **or** quantitative criteria.

21 Staff have identified the following as reasons <u>supporting</u> using a mix of qualitative and quantitative thresholds to delineate the entities that would fall into each reporting Tier:

- when either qualitative or quantitative criteria can be met, this would allow an entity to first consider whether it meets a quantitative threshold without the need to apply judgement;
- consistency with the approach adopted by New Zealand. NZ PBE entities are sorted into reporting Tiers on the basis of their public accountability status and/or extent of expenses. However, staff note that paragraph 65 of the Explanatory Guide to NZ XRB Standard A1 *Application of the Accounting Standards Framework* suggests that the majority of NZ NFP PBEs would not meet the public accountability criterion, rendering it largely moot for the NZ NFP private sector. The Basis for Conclusions to NZ XRB Standard A1 (paragraph BC30) also indicates that the public accountability criterion was included to prevent a public sector entity from being incentivised to define itself as a for-profit entity or a PBE in order to be able to elect to report in a lower tier; and
- in essence, requiring a mix of qualitative and quantitative thresholds to be met would not be significantly different to providing guidance in the form of quantitative thresholds as indicators of the existence of a qualitative threshold.

22 Staff have identified the following as reasons <u>against</u> using a mix of qualitative and quantitative thresholds to delineate the entities that would fall into each reporting Tier, in addition to reasons identified in paragraph 18 above:

- more complex than using just quantitative thresholds or qualitative thresholds. Rather than specifying thresholds that employ both qualitative and quantitative criteria, qualitative thresholds could be accompanied instead by guidance/indicators that might be quantitative in nature; and
- may suggest an erroneous message, as the quantitative thresholds might be interpreted to be different from the qualitative criteria, rather than being related to the qualitative criteria. For example, criteria such as 'the entity has public accountability and/or has revenues of $x or greater' may suggest that the size of its revenues is not an indicator of its public accountability.

Staff view

23 The staff preference is to first develop options for possible stratification of NFP private sector entities into each reporting Tier based on qualitative criteria for the Board's consideration for the purposes of its discussion paper. This is primarily because staff think that the applicability of accounting requirements should, as far as possible, be based on principles and not rules.

Reflecting on the possible capitalisation outcomes resulting from applying the IASB's 'USD5,000 low value lease' informal threshold across jurisdictions of differing economic situations, staff's view is that it would be difficult to develop size thresholds that adequately reflect differential significance of the Australian NFP private sector population, in part having regard to the economic differences between different Australian jurisdictions. Staff also think that using quantitative thresholds has the potential to introduce further complexity as an entity may be required by the regulatory body to consider a size threshold to determine whether it is required to prepare financial statements, and then a further size threshold to determine which reporting Tier it needs to comply with. Also, these size thresholds may not be similar, for example, the regulatory threshold may be based on revenues while those specified by the Board might be based on revenues plus further criteria.

24 However, staff are cautious that it might not be possible to identify workable qualitative criteria; having regard to the fact that Australian regulatory bodies, the UK, and New Zealand have all based their reporting thresholds on quantitative criteria. If so, staff would then need to bring to a further future Board meeting a different set of criteria for the Board's consideration.

Question for Board members	
Question 2	Do Board members support the staff proposal that staff first develop options for possible stratification of NFP private sector entities into each reporting Tier based on qualitative criteria for the Board's consideration for the purposes of its discussion paper?

APPENDIX: FEEDBACK FROM TARGETED OUTREACH CONDUCTED BETWEEN AUGUST – OCTOBER 2020

The following feedback from staff outreach activity was conveyed to the Board as part of Agenda Paper 5.1 from the AASB 16-17 September 2020 meeting and Agenda Paper 3.1 from the AASB 11-12 November 2020 meeting. The 'staff proposal of possible design' used to facilitate outreach discussion are the possible design proposals contemplated in the NFP Private Sector Project Plan discussed by the Board at its AASB 21 November 2019 meeting.

Matters discussed	Staff proposal of possible design	Initial feedback received from staff of federal, state and territory regulators and Project Advisory Panel members
Reporting tier threshold determinant	Consolidated revenue to determine the size of the entities and consequently the reporting requirements	Most stakeholders were concerned about revenue volatility and its implication on entities crossing the thresholds year on year. One panel member believed that any selected reporting threshold should be justified from the perspective of user needs. Some suggested using inflationary adjustments three-year averages to smooth out revenue fluctuations. Some suggested considering other metrics such as assets and/or number of employees which not only provide more stability in size determination but also reflect unique circumstances of some NFP entities with significant asset bases but without significant revenue. Some raised implication of not differentiating between revenue and income as potential contributor to entities crossing thresholds in case of sole determinant. Staff of regulators expressed mixed views on using consolidated revenue as tier threshold: • [One] mentioned the current use of consolidated revenue or income as their primary tier threshold in their jurisdiction and therefore did not object to the staff proposals. • One confirmed its current practice requires consolidation if the reporting entity controls other entities, even though its reporting threshold is not explicitly referred to as "consolidated revenue". • Others currently require the size to be determined and financial reports to be prepared on a single entity basis and therefore expressed concerns <u>Additional initial feedback included in Agenda Paper 3.1 from the AASB November 2020 Meeting:</u> • interaction between the definition of the tiers and reporting requirements is important to determine where to draw the line between Tier 3 accrual accounting and Tier 4 cash accounting; • application of tiers needs to be clear for entities to have sufficient guidance on what reporting requirements are relevant for them; and

Matters discussed	Staff proposal of possible design	Initial feedback received from staff of federal, state and territory regulators and Project Advisory Panel members
		• compared with qualitative thresholds based on which entities are currently able to prepare SPFS, quantitative thresholds are easy to implement and involve less judgement, thus would work better for NFP entities. • revenue should not be the only determinant for tier thresholds, e.g. some NFPs with a large once-off establishment donation would result in having higher reporting requirements, despite lower on-going income in subsequent periods.
Thresholds definition	To define the reporting tiers in the Australian Accounting Standard (AAS)	Many stakeholders did not comment. However, those who did comment had mixed views. • staff of two regulators supported the proposal of defining the tiers within AAS as their view defining the tiers by legislation or regulations would require the states and territories to reinvent the terminology and make the compliance more complicated. • staff of other regulators pointed out that to conform reporting thresholds, regulators would be required to standardise legislations across different jurisdictions. In absence of this, defining the tiers in AAS could add confusion for entities to work out which reporting requirements apply to them. • one panel member suggested using ACNC thresholds as underpinning framework given the on-going alignment of state, territory, and ACNC regulatory obligations for applicable entities. • staff of one regulator highlighted the potential need to allow flexibility in AAS to accommodate for any future changes to the regulatory thresholds.