



A GUIDE TO UNDERSTANDING THE FINANCIAL REPORTS OF NOT-FOR-PROFIT ENTITIES

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FOREWORD

Australia's not-for-profit sector is large and diverse. It has a strong history of helping vulnerable and disadvantaged people across a range of areas such as health, social services, education, human rights, welfare and the environment. The sector has the power to touch almost all Australians in some way, either directly or indirectly through family, friends and colleagues.

The not-for-profit sector is also important to Australia's economy. In 2006–07, it's estimated that there were approximately 600,000 not-for-profits in Australia, contributing around \$43 billion to our economy and employing nearly 890,000 people. Moreover, almost 4.6 million Australians volunteer their time and expertise to make a positive difference to our world.

CPA Australia's *A guide to understanding the financial reports of not-for-profit entities* will be of value to a range of stakeholders, including those who work in not-for-profits, to better understand the accounting and regulatory aspects of not-for-profit financial reporting.

The guide is an initiative of the External Reporting Centre of Excellence of CPA Australia. I congratulate the Centre on its contribution to this CPA Australia publication, which has an important role to play in the promotion of financial literacy.

Alex Malley FCPA

Chief Executive
CPA Australia Ltd

INTRODUCTION

THE PURPOSE OF THIS GUIDE

This guide is intended for the external users of financial statements prepared by not-for-profit (NFP) entities in Australia, such as members of not-for-profit entities, donors and funding providers. In addition, the management and staff of NFPs may also find the guide useful. The guide will assist users to better understand the content of the financial statements and other accompanying documents of NFPs.

To assist understanding, the guide provides in the appendix extracts from the financial statements of Koala Ridge Beach Life Savers Incorporated (hereafter referred to as Koala Ridge), a fictitious charitable NFP entity which provides lifeguard services and other beach-related activities for visitors to a popular Queensland beach. It should be noted that the example provided in the appendix does not constitute a full set of financial statements and the extracts are presented only to demonstrate key aspects of the financial statements of an NFP. In addition, the guide includes some general material about the Australian NFP sector.

A DIVERSE NFP SECTOR

The feature common to all NFPs is that they are not set up to generate a return for their members. That said, NFPs can and do generate **profit** or **surplus**. However, any profit or surplus cannot be distributed to members. Beyond this common feature, the differences in legal form, size, type and objectives are numerous.

The legal form of NFPs can be very different. Many are informal associations that are created by like-minded individuals with a common purpose, and do not take a particular legal form. These are commonly referred to as unincorporated associations. Some NFPs are formed as an **incorporated association** under state or territory laws, as companies limited by guarantee, or indigenous corporations under Commonwealth corporations law. Other legal structures include trusts and co-operatives. More information on some of the statutory requirements relevant to NFPs is provided in the CPA Australia guides *Charities: A guide to financial reporting and assurance requirements* and *Incorporated associations: Reporting and auditing obligations*.

Charities form one distinct subset of NFPs, with their objectives being primarily of a charitable nature. The legal meaning of **charity** includes the charitable purposes of relieving poverty, sickness or the needs of the aged, advancing education, advancing religion and other purposes beneficial to the community. Examples that would fall within the other purposes category include providing not-for-profit childcare services, advancing arts and culture, health, promoting animal welfare and protecting the environment. An overwhelming majority of NFPs are not charities and they can exist for the exclusive benefit of members, or to serve a specific group of people, community or purpose. Examples include clubs formed for a social, recreational or sporting purpose, and professional and trade associations.

LAWS AND REGULATIONS

The activities NFPs are involved in often have a profound social and economic impact and some NFP entities such as charities exist solely to engage in activities that are for the public benefit. Many NFP entities rely on financial support from government and the philanthropy of private benefactors to achieve their objectives. As a result of these unique attributes, laws and regulatory frameworks have been developed over the years by state, territory and Commonwealth governments to regulate the NFP sector. Some of these laws include provisions setting out governance and reporting requirements.

WHY ARE FINANCIAL STATEMENTS REQUIRED?

Depending on the structure of the NFP, its governing legislation may require periodic financial reporting as part of its governance obligations. Funding providers (both private and government) often require financial statements as part of their acquittal process. Members and other stakeholders can also impose financial reporting obligations through an NFP's constitution or other means. Financial statements are also used for internal purposes by the management and staff. However, the needs of internal users and those of external users, for whom this guide has been written, are not necessarily the same.

Financial reporting by NFPs provides information to users to demonstrate effective stewardship and accountability, and to assist their decision-making. NFPs are normally accountable to those that provide them with resources, and those that depend on them for the services or goods they provide. The financial reporting by NFPs provides information on how they have discharged their accountability obligations about the management of the resources entrusted to them for the delivery of services or goods to stakeholders, and compliance with legislation, or other authority that governs the delivery of services or goods and other operations. Financial reporting by NFPs is also intended to aid users by providing information that assists them in deciding whether or not to provide resources including financial resources. For example, a private donor looking to make a significant monetary donation to a charity may examine and analyse its financial statements to establish the financial performance and stability of the entity before making a donation.

Often NFP financial statements are independently audited or reviewed. This may be undertaken to comply with statutory or other requirements, or voluntarily by the NFP. An audit or review provides additional comfort or **assurance** to users about the accuracy of information contained in the financial statements.

The form and content of financial statements prepared by NFPs can vary significantly depending on their size, type, and statutory or other requirements. This guide includes excerpts from the financial statements of a small to medium-sized charitable NFP. Future iterations of this guide will also address financial statements that smaller or micro NFPs prepare, including those that are prepared on a cash-basis. The following section considers the different types of financial statements prepared by NFPs in more detail.

WHAT ARE FINANCIAL STATEMENTS?

Most people use the terms “financial statements”, “financial report” and “annual report” interchangeably when talking about the annual documents produced by NFPs. However, the reality is that the terms financial statements and financial report have special legal meanings that are contained in various laws applicable to NFPs around Australia. The term annual report is less defined but is generally considered to include all documents that are prepared annually by an NFP to inform readers about its activities and achievements, performance and financial position for the year. Normally the annual report will incorporate the financial report and financial statements, as well as other information.

The following illustration demonstrates the relationship between the financial statements, the financial report and the annual report, and provides examples of the common content contained in these documents. It should be noted that not all the examples of content provided below will always be included, as this will depend on a number of factors, including the size of the NFP, accounting basis adopted, applicable legislation or other requirements and **accounting standards** applied in preparing the financial statements, financial report or annual report.

Illustration 1

ANNUAL REPORT:

- Chairman’s statement
- Service performance report

FINANCIAL REPORT:

- Audit report or review report
- Management committee or directors’ report (or equivalent)
- Management committee or directors’ declaration (or equivalent)
- Notes to the financial statements

FINANCIAL STATEMENTS:

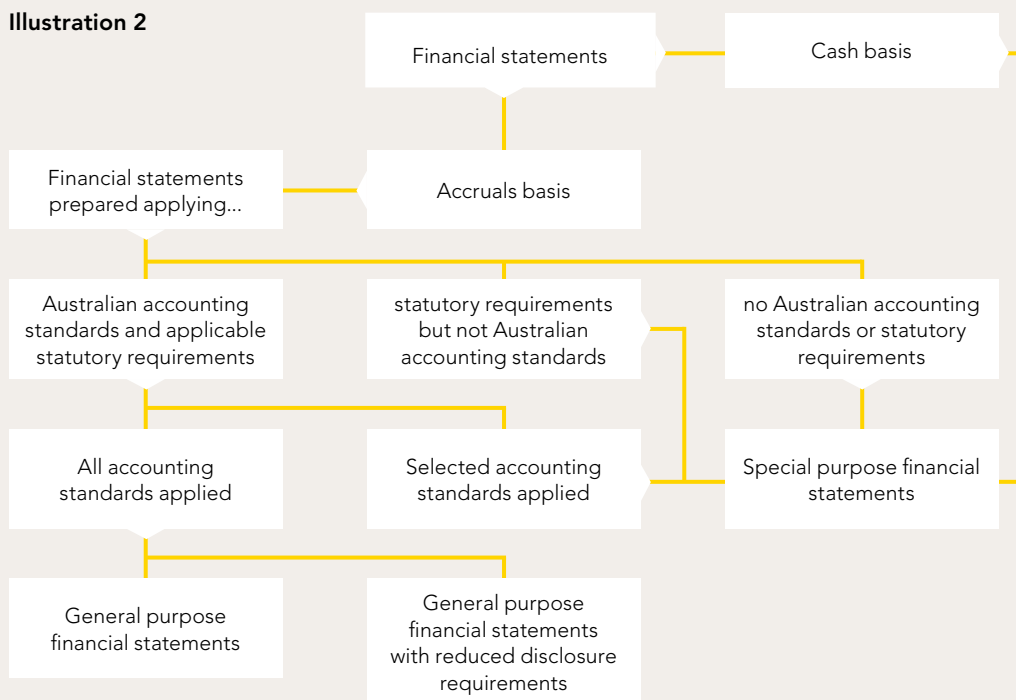
- Statement of comprehensive income (income statement, profit and loss account, or statement of profit or loss and other comprehensive income)
- Statement of financial position (balance sheet, statement of assets and liabilities)
- Statement of changes in equity (statement of changes in funds, statement of changes in reserves)
- Statement of cash flows (cash flow statement)

FINANCIAL STATEMENTS AND FINANCIAL REPORTS

Financial statements will typically provide financial information about the NFP’s financial performance over a period of time (commonly a financial year) and the financial position at the end of that period of time. Other information that may be presented in financial statements includes information on the cash flows arising during the year.

As stated earlier, the form and content of financial statements will depend on the criteria applied in their preparation. The illustration below identifies some of the common bases and criteria applied in the preparation of NFP financial statements.

Illustration 2



As illustrated above, financial statements may or may not be prepared in accordance with Australian accounting standards (hereafter referred to as accounting standards). This will depend on the purpose of the financial statements and other factors including applicable legislation.

Illustration 1 includes the four primary statements that will be included in financial statements that are prepared in accordance with accounting standards. The excerpts from the financial statements of the fictitious NFP entity Koala Ridge provided in the appendix include examples of the four primary statements.

- The statement of comprehensive income (also referred to as profit and loss account, or income statement) provides information on the entity’s financial performance by reporting the financial (or monetary) value of all events that have changed the value of the **assets** and **liabilities** of the NFP. These changes in value are represented as items of income and expenditure with the net difference presented normally as a surplus or **deficit** (some NFP entities also use the terms profit or **loss** instead, which is the standard terminology used by a profit-oriented entity).

- The statement of financial position (also referred to as balance sheet) shows the monetary measure of all the resources controlled by an NFP (assets) and all the obligations due by the NFP (liabilities) at the year-end, classified as current or non-current in order of **liquidity**.
- The statement of changes in **equity** reports all changes in the reserves (or funds) held by the NFP during the financial period.
- The cash flow statement shows the cash inflows and outflows for the financial period from operating, investing and financing activities.
- Directors' or management committee declaration (or equivalent): In financial reports prepared under the Corporations Act 2001, the directors' declaration will include statements from the directors that the financial statements and the notes comply with accounting standards and give a true and fair view, and there are reasonable grounds to believe that the entity is solvent. Other legislation or requirements applicable to NFP entities and imposing financial reporting obligations can also include a requirement for a declaration by the management committee (or their equivalent).

The term financial report is often used interchangeably with the term financial statements, but normally denotes the document that incorporates the financial statements and some additional information arising from legislative or other requirements. For example, in a Corporations Act setting, a financial report will, in addition to the financial statements, include the notes to the financial statements and a declaration by the directors. Other common content considered part of financial reports includes:

- **Audit report or review report:** The report by the auditor or reviewer sets out their conclusions drawn in the form of an audit or review opinion, and a brief background on respective responsibilities of the auditor or reviewer and basis for arriving at the opinion. The different types of conclusions and the level of assurance an auditor or reviewer draws and expresses through their opinion are provided in the section "Audit/review of NFP financial statements" below.
- **Management committee report (or directors' report, or equivalent):** The group of individuals entrusted with the governance of the NFP may be referred to as directors, trustees, or management committee, and the report they provide will reflect their title. The management committee report (or equivalent) will normally include names of the management committee members (or directors or equivalent), a review of the operations and activities of the NFP, objectives of the NFP and the strategies to achieve these objectives. Risks faced by the entity, and future plans may also be included in the report.
- **Chairman's statement:** This document is normally voluntary, providing a high-level overview of the entity's performance, activities and strategies. The chairman's statement is normally an "impact" document appearing at the front-end of the annual report to showcase an entity's achievements and outcomes.
- **Service performance report:** Financial statements normally include information about an NFP's financial performance and financial position. Increasingly, information about an entity's non-financial performance is also being included to demonstrate to stakeholders how an entity has performed in achieving its objectives. This narrative approach to performance reporting is particularly relevant to NFPs. Unlike a profit-oriented entity with an objective of providing a return to its investors, NFPs can have a range of different objectives. For example, a golf club's objectives may be to provide a range of golf-related and other recreational services to its members, whilst an aged care charity might focus its objectives on providing specialist care services. The non-financial metrics and discursive information provided in a service performance report can enable an NFP to demonstrate how it has performed in achieving its objectives.

ANNUAL REPORT

In addition to content included in the financial statements and financial report, and depending on the legislative or other requirements, the content of an annual report can vary. Commonly information contained in the annual report above and beyond information in the financial report will fall outside the scope of an audit or review. A synopsis of common types of content included in the annual report is provided below:

IMPORTANT FEATURES OF NFP FINANCIAL STATEMENTS

TYPES OF FINANCIAL STATEMENTS

Within the NFP sector, significant differences exist in the form and content of financial statements (or financial reports) prepared by different NFPs. These differences arise due to the wide range of activities NFPs are involved in, the needs of different stakeholders, the legal form of the NFP, and the different laws and regulations that apply to NFPs. Some common differences in types of financial statements are explored below.

FINANCIAL STATEMENTS PREPARED ON A CASH BASIS OF ACCOUNTING VS. AN ACCRUALS BASIS OF ACCOUNTING

Cash basis of accounting

Under this most simple method of accounting, only the cash receipts and cash payments are recorded and presented in the statement of comprehensive income. Cash balances at the end of the financial year (at the bank and on hand) may also be presented alongside the statement of comprehensive income. Financial statements presented on a cash basis may also include some other assets in addition to cash balances and liabilities alongside the statement of comprehensive income. Such additional information presented is usually easily obtainable without the need to rely on expert accounting knowledge.

The cash basis of accounting is more common amongst the smallest or micro NFPs with typical annual income and expenditure of no more than a few thousand dollars, and with minimal resources and expertise at the NFP's disposal for accounting and financial reporting purposes. In these circumstances, there are likely to be no or minimal legal and regulatory requirements for financial reporting. It should be noted that for larger and more complex NFPs the cash basis of accounting will not meet the needs of users.

Accruals basis of accounting

The accruals basis of accounting is widely accepted as the more appropriate method for preparing financial statements, and the Australian accounting standards are based on the accruals basis of accounting. Under the accruals basis, income is recognised when it is earned and expenditure is recognised when it is incurred. Therefore, income recognised will include cash that has not yet been received but the entity has earned a right to it, either through delivery of services or goods, or through a binding

commitment from a third party. Expenditure recognised will include costs incurred but not yet paid, where either goods or services have been received or binding obligations have been committed to. Expenses also include depreciation, which is an annual expense to reflect an entity's use of its assets such as furniture and fittings, buildings, computer equipment and other such assets. In addition to physical assets and cash, assets and liabilities recognised will include other financial assets such as debtors (receivables for earned income not yet received at the end of the financial year) and, financial liabilities such as creditors (payables for expenditure incurred and services used that have not yet been paid at the end of the financial year).

Sometimes an NFP will be the parent entity in a group, controlling one or more other entities (called subsidiaries, which can be NFPs or for-profit entities). The parent entity of a group preparing financial statements in accordance with accounting standards will prepare and present consolidated financial statements that include the financial information for all the entities within that group.

GENERAL PURPOSE FINANCIAL STATEMENTS (GPFS) VS. SPECIAL PURPOSE FINANCIAL STATEMENTS (SPFS)

GPFS refers to financial statements that are prepared by applying all relevant accounting standards. In some instances, a legal or other requirement such as the NFP's constitution may require an NFP to prepare GPFS. In other situations, the NFP's management committee or accountant might judge that GPFS are required due to the existence of a wide range of users who may rely on them, regardless of any legal or constitutional requirement. GPFS are normally intended for a wide range of users.

SPFS refers to all financial statements that are not GPFS. Depending on the law relevant to the NFP or its constitution, the application of a minimum set of accounting standards might be required. Otherwise, the NFP can select the accounting standards it applies in preparing SPFS, which are usually intended for a narrow range of users.

FEATURES OF EACH OF THE FOUR TYPES OF PRIMARY STATEMENTS THAT CAN BE INCLUDED IN FINANCIAL STATEMENTS

The content of the financial statements of an NFP differ from a profit-oriented entity's financial statements in a number of ways. This is due to the unique activities and objectives of NFPs and the different information needs of users of NFP financial statements. The applicable legal and regulatory frameworks can also give rise to differences in the content of the NFP financial statements. Highlighted below are some of the unique features within the four primary statements that can form part of an NFP's financial statements.

Statement of comprehensive income (or profit and loss account, or income statement)

NFPs can generate income for the pursuit of their objectives by obtaining funds from providers, who do not receive any direct benefit in return for the provision of funds. NFPs can also generate income in a similar way to profit-making entities, by earning revenue in return for the provision of goods or services. The example statement of comprehensive income of Koala Ridge on page 21 includes income types common to NFP entities, such as:

- Grants – Government agencies and private sector entities may provide grants to NFPs to either carry out the activities they are set out to undertake, or for specific prescribed activities.
- Donations – Philanthropy is a significant source of funds for the NFP sector and income received as donations is a common element of income for NFPs. Donations can either be received for the general activities and objectives of an NFP, or to fund particular activities. Bequests, gifts, legacies and endowments all fall within the category of donations. Whilst donations can take

monetary form, donations in kind are also common, including donated goods and services. Volunteers' time would normally be classified as donations in kind. NFPs can often find the valuation of donations in kind to be challenging, especially those with limited resources and accounting and valuation expertise. It can be further complicated when comparable or benchmark information on financial value is not available. Koala Ridge receives donations in kind, in the form of donated goods, as can be seen in the inventories (note 2 on page 25).

- **Fundraising** income – NFPs may also generate income through fundraising events (for example a school fete) or activities (such as a raffle). Whilst some fundraising activities will involve provision of goods or services in return for income, other activities may not. In order to undertake fundraising activities, NFPs are also commonly required to obtain a license under local state or territory laws and comply with fundraising legislation, which can include financial reporting obligations. Koala Ridge's statement of comprehensive income on page 21 indicates that it receives fundraising income (fundraising appeals). In addition, the entity has raised funds through a sports tournament (beach cricket tournament collections) which also falls under the broad heading of fundraising income.
- **Membership** income – Subscriptions or fees paid by members of an NFP often allow members to enjoy certain benefits and facilities provided by the NFP. Entities will need to determine how this revenue is most appropriately recorded, either on receipt or spread over a period of time. Recognition can depend on what the members get in return from the NFP for the subscriptions or fees paid, and the basis of accounting adopted by the NFP (cash basis or accruals basis).

- Trading income – Many NFPs operate trading facilities (such as a shop or bar) as part of their activities, with the profits or surplus generated from such activities utilised for the primary objectives of the NFP. The trading activities of Koala Ridge ascertained from its statement of comprehensive income on page 21 include operating a bar (bar income), hiring out equipment (equipment hire), operating a gymnasium (gym fees) and hiring out a hall (hire of hall).
- Investment income – NFP entities may hold investments that generate income for a number of reasons. Some may do so as part of their overall strategy to achieve their objectives, or even as a requirement set out in their constitution. Others may acquire investments from time to time when they have excess funds that are earmarked for future expenditure. Koala Ridge's statement of comprehensive income on page 21 indicates that it receives investment income in the form of dividends and interest.

In order to conduct its activities an NFP will incur expenditure, which is presented in the statement of comprehensive income. Expenses can either be analysed by their nature (such as transport costs, employee expenses and depreciation) or by their function (for example cost of sales, cost of distribution or administrative expenses). The example statement of comprehensive income on page 21 uses the "nature of expense" method and the descriptions used for the expenses presented are self explanatory.

Statement of financial position (or balance sheet)

NFPs may hold and operate a range of different assets that provide them with economic benefits. Some of these assets that are held, and provide benefit, over the long term are classified as non current assets. Assets that provide benefits over the short term (usually within one year) are classified as current assets. In fulfilling their objectives, NFPs also enter into commitments

and obligations that give rise to liabilities. Similar to assets, liabilities are either current (short term, usually requiring settlement within the following financial year) or non current (due after more than one financial year). The difference between assets and liabilities (net assets or net liabilities) represents the equity the NFP holds. Some common features of the assets and liabilities of an NFP and some of the challenges in relation to the measurement and presentation of the financial values represented by these assets and liabilities are discussed below.

- Asset values and impairment – Operational non-current assets held by NFPs (land, buildings and other property, plant and equipment) are often utilised for purposes that may not represent the best financial return. In particular, a commercial return is often not charged. For example a charitable NFP, as part of its objective to provide poverty relief, may own a property that is used to provide subsidised or free accommodation to homeless individuals, rather than charge market rates. Where an entity chooses to carry its non-financial asset at fair value, rather than at cost, AASB 13 Fair Value Measurement requires the fair value measurement to reflect the "highest and best use" for that asset, which requires consideration of uses that are physically possible, legally permissible and financially feasible. NFPs that fair value non-financial assets and hold and use such assets for what may be less than financially optimal purposes may encounter challenges in measuring such assets at fair value. More information on issues relating to the valuation of assets in the NFP sector can be obtained from the guide *Valuation and depreciation: A guide for the not-for-profit and public sector under accrual-based accounting standards*.
- Heritage assets – Some NFPs hold assets of heritage or artistic value (such as art collections, heritage buildings or park land) that give rise to valuation challenges.

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- Investment assets – NFPs can hold investments that provide them with a financial return to fund their activities. Investment assets can include financial investments (such as shares or bonds) or investment property. Investment assets can either be donated to the NFP or acquired by the NFP to further its objectives.
 - Equity, funds or reserves – The net financial value of assets less liabilities that an NFP holds can be split amongst various classes of equity, funds or reserves. A general (or retained) reserve is the most common type of reserve that represents the common pool of net assets available to the NFP to fulfill its general objectives. An NFP adopting an accounting policy of presenting some of its assets on a revalued basis will also include an asset revaluation reserve that includes the cumulative revaluation gains or losses arising on the revalued assets.

A statement of changes in equity (or statement of changes in funds or reserves) will normally provide information on changes in the funds or reserves of an NFP, including opening and closing balances, net surplus or deficit (profit or loss) and transfers between funds (where permitted).

A statement of cash flows provides information on the cash inflows and outflows of the NFP, classified by different types of cash flows. As illustrated in the example on page 24, the statement of cash flows can include cash flows from operating activities, investing activities and financing activities.

The descriptions used for the three main categories of cash flows in the statement of cash flows are self explanatory. Cash flows from operating activities will include cash receipts (inflows) and payments (outflows) from the day-to-day operations of the NFP. The example on page 24 includes interest and dividend income under operating activities, however entities have a choice (which they have to apply consistently every year) on whether such cash flows should be included under operating activities or investing activities. Cash flows from investing activities will normally include payments and receipts on purchase and disposal of investments. Cash flows from financing activities for an NFP will normally include capital injections from members, loans received and loans paid, and as illustrated in the example on page 24, Koala Ridge includes repayments of the bank loan it owes under this category.

AUDIT/REVIEW OF NFP FINANCIAL STATEMENTS

Financial statements can be audited or reviewed for a number of reasons. Examples include obligations arising from applicable legislation, requirements placed by funding providers, or a requirement arising from an NFP's own constitution or its members.

The level of comfort that a user can derive from an audit and a review differs. An audit will normally enable the auditor to obtain a higher or reasonable level of assurance in arriving at audit conclusions that will form the basis of the auditor's opinion expressed in the audit report. In a review engagement, the reviewer will normally undertake a less detailed engagement compared to an audit, that enables the reviewer to obtain a limited level of assurance in arriving at the conclusions that will form the basis of the reviewer's opinion expressed in the review report.

It should be noted that "absolute" or "total" assurance (such as a certification that the financial statements are completely correct) cannot be achieved through an audit (or review). The Australian auditing standards (ASA) issued by the Australian Auditing and Assurance Standards Board (AUASB) provide the framework for conducting audits in Australia. An audit

performed by applying the ASAs is designed to enable the auditor to identify material inaccuracies or misstatements in the financial report and results in an opinion by the auditor on whether the financial report presents fairly or gives a true and fair view of, the financial position, financial performance and cash flows (as applicable) of the entity, in all material respects. If stipulated by legislation or other requirements, the auditor may also state in the audit report whether the financial report is prepared in accordance with applicable accounting standards and legislation.

The AUASB issues Australian standards for review engagements (ASRE) to assist in the conduct of review engagements. The opinion arising from a review engagement is normally in a negative form, for example the reviewer will provide a conclusion that nothing has come to their attention to indicate that the financial report does not present a true and fair view. More information on audits and review can also be obtained from CPA Australia's *Guide to understanding auditing and assurance: Listed companies*.

The following table summarises example auditor and reviewer opinions.

Type	Example opinion
Audit	<p>In our opinion:</p> <ul style="list-style-type: none"> • The financial report of XYZ Association is prepared in accordance with the Associations Incorporation Act 1981, including: <ul style="list-style-type: none"> – Giving a true and fair view of the Association's financial position as at [date], and of its performance for the year ended on that date; and – Complying with the Australian accounting standards.
Review	<p>Based on our review, which is not an audit, nothing has come to our attention that causes us to believe that the financial report of XYZ Association for the period ended [date] does not give a true and fair view of the financial position of XYZ Association as at [date], and of its financial performance and its cash flows for the year then ended, in accordance with [applicable financial reporting framework and legislation].</p>

HOW TO READ NFP FINANCIAL STATEMENTS

There are similarities and differences in the information needs of users of NFP financial statements, and the information needs of users of for-profit financial statements.

The following table illustrates some of the key differences and similarities.

Common questions asked by users of for-profit financial statements

- What is the profit (or loss) made by the entity in the financial year?
- What is the financial strength of the entity?
- Does the entity generate a satisfactory return on my investment?
- Does the entity have a viable and sustainable future?
- Is this an entity I can invest in, or lend money to?
- How effective is the entity's management?

Common questions asked by users of NFP financial statements

- How well has the entity performed in meeting its objectives?
- What is the financial strength of the entity?
- Has the entity fulfilled its commitments in exchange for funds received?
- Does the entity have a viable and sustainable future?
- Is this an entity (or activity undertaken by the entity) I want to donate to or contribute funds to?
- How effective is the entity's management?

As noted above, there are similarities and differences in questions asked by users of the two types of financial statements. Although some of the questions can be similar, the underlying reasons for asking these questions may differ. For example, the user of a for-profit entity financial report may seek to know how well the entity is being managed in generating returns for its investors, whilst the same question may be asked in an NFP scenario to establish if the entity is fulfilling its objectives satisfactorily.

STEP 1 – UNDERSTANDING THE ENTITY

Before commencing the analysis of an NFP's financial report, it is important to obtain a good understanding of the entity, including their:

- Primary objectives, governance structure, and area of operation and activities – This information can be obtained from sources such as the NFP's governing document (such as constitution or trust deed), from the management committee's (or equivalent) report, or the chairman's report. The NFP's governing document may be obtainable from the NFP, or in some cases from a public source such as the ACNC online portal, or a copy of a Victorian incorporated association's rules from Consumer Affairs Victoria (for a fee).

- Legal form – NFPs operate under various legal structures, including incorporated associations, companies limited by guarantee, trusts and co-operatives. As stated earlier, some entities are not formed under any particular legislation or statute, and are commonly referred to as unincorporated associations.

As stated above, an understanding of the entity can be obtained by reading some parts of the annual report. Some NFPs include a chairman's report or a service performance report in their annual report. The content of these reports usually includes a discussion of the entity's performance highlights in the context of its objectives. Whilst reading these reports, users should be mindful that an audit or review would not normally extend to the information contained in them and an objective and analytical approach is recommended when considering such information.

STEP 2 – THE AUDIT REPORT OR REVIEW REPORT

The opinion of the auditor or reviewer can provide further insight into the veracity of the information presented in the financial statements. In an earlier section, we considered the difference between an audit engagement and a review engagement and the differences in the opinions provided by the auditor and the reviewer in their respective

reports. If the auditor concludes at the end of the audit engagement that the financial report presents fairly or gives a true and fair view, the audit report will reflect this opinion. If required, the auditor may go on to state that the financial report is prepared in accordance with accounting standards and legislation (as appropriate). This is sometimes referred to as an unqualified or clean opinion. The requirement to prepare financial reports that give a true and fair view commonly arises from statutory requirements (for example the *Corporations Act 2001* or *Associations Incorporation Reform Act 2012*).

If a reviewer concludes at the end of the review engagement that the financial report “presents fairly” or gives a true and fair view, the reviewer will provide a conclusion that nothing has come to his or her attention that the financial report does not present a true and fair view. Additional statements about compliance with accounting standards and legislation may also be provided if required.

Sometimes, an auditor or reviewer may conclude either that the financial statements contain a **material misstatement**, or that the auditor or reviewer has been unable to gather sufficient evidence to form an opinion. Users of financial statements should carefully read the audit report or review report to identify if the opinion has been modified or “qualified” as a result, and also read carefully why the auditor or reviewer has issued such an opinion. For example, a situation that can sometimes arise in the NFP sector that gives rise to a **modified opinion** is when material cash donations are received. Auditors and reviewers can encounter practical difficulties in gathering sufficient evidence over the completeness of income received from cash donations due to the manner in which such donations are generated (such as through street collections). In such instances auditors and reviewers may seek alternative sources of evidence and perform alternative testing procedures. This could be achieved by testing and placing reliance on good internal controls, but if this is not possible, a modified or qualified opinion may be issued by the auditor or reviewer.

Auditors or reviewers may also include **emphasis of matter** paragraphs. Whilst such paragraphs do not denote a qualified audit or review report, they are included to highlight certain aspects the auditor or reviewer believes are important to draw

to the readers’ attention, for an understanding of the financial statements. Such emphasis of matter paragraphs may, for example, be included when an audit or review highlights material uncertainties over the continuing ability of the NFP to operate into the foreseeable future (commonly referred to as the **going concern assumption**).

STEP 3 – READING THE FOUR PRIMARY STATEMENTS

Earlier sections contained a discussion of the types of financial information provided through each of the four primary statements that constitute the entity’s financial statements, and some of the common elements and features. The following sections consider how to assess the NFP’s financial performance and financial position through the four primary statements.

The statement of comprehensive income sets out the income earned, expenditure incurred and the net surplus or deficit for the financial period. The level of detail for income and expenditure can vary, with some entities providing more detail on the face of the statement, whilst others provide detail in the notes. The statement of comprehensive income for Koala Ridge is an example where some level of detail is provided through the line items presented for income and expenditure. In addition to the income and expenditure for the current period, the income and expenditure for the prior period is also provided to enable comparison of financial performance from the last period to the current period. Provision of comparative figures is a requirement of accounting standards.

When considering the surplus (or deficit) of an NFP it is important to be mindful of two features specific to NFPs:

- The focus of an NFP is not to generate a surplus (or profit) for the benefit of its members and it is not uncommon for an NFP to consistently achieve small surpluses (or deficits) every year.
- Even if a significant surplus (or deficit) is achieved in a particular financial year, this does not necessarily indicate good or bad financial performance in that year. The information should be considered in conjunction with other information in the financial report that may provide an explanation for the surplus (or deficit). It is common for grants received by NFPs to be recognised when received, and

the related expenditure recognised when incurred in subsequent years. This can result in a timing mismatch of the grant receipt and the related expenditure. Consequently, a surplus could arise in the year the grant is received and recognised, and a deficit could arise when the related expenditure is incurred and recognised. So in order to obtain a proper appreciation of the reason for significant surpluses (or deficits), it is important to assess the information provided in the other primary statements and notes to the financial statements.

Koala Ridge's statement of comprehensive income on page 21 indicates that the NFP made a surplus of \$14,686 in 20XB and a higher surplus of \$84,026 in 20XC. When observing the various income streams of Koala Ridge, it is possible to identify a significant increase in grant income from \$67,142 in 20XB to \$152,348 in 20XC.

An examination of the extract of note 5 on page 25 provides the reason for the higher surplus, and increase in grant income during 20XC. During 20XC, Koala Ridge received a grant from the local council of \$100,000 to be spent on purchasing themed uniforms and equipment for the lifeguards, and to provide them with advanced training to improve their existing skills. The grant income is unconditional, hence Koala Ridge has recognised all of it as income during the year, but as none of the expenditure has been incurred, a substantial surplus arises for the year. In future years, when the expenditure occurs but the income has been previously recognised, a deficit may arise.

The level of detail provided in Koala Ridge's statement of comprehensive income lends itself to further analysis of income and expenditure by specific activities. For example:

For the year ended 20XC	Fundraising \$	Beach cricket tournament \$	Bar \$	Hall hire \$
Income	50,842	10,244	4,223	39,422
Expenditure	31,111	11,482	5,924	29,842
Activity surplus/(deficit)	19,731	(1,238)	(1,701)	9,580

A note of warning however – when analysing income and expenditure for specific activities, bear in mind that while the direct expenses relating to specific activities may be identifiable, general overhead expenditure incurred by the NFP may not be allocated to expenses relating to specific activities. For example, the employee costs of \$99,836 incurred by Koala Ridge in 20XC may have included the cost of employees undertaking some of the specific activities set out in the above table, which has not subsequently been allocated to the direct expenses relating to the specific activities.

In addition to income and expenditure, the statement of comprehensive income also includes other gains and losses generated during the year. These other gains and losses are not included in the calculation of the surplus or deficit arising. One example is a revaluation gain on a non-financial asset, such as land. Because the revaluation gain is not available as a resource to

the entity until the asset is disposed, the gain is not included in calculating the NFP's surplus or deficit. The statement of comprehensive income of Koala Ridge does not include any such gains or losses as none arose in 20XB or 20XC.

The statement of financial position provides information on the assets and liabilities of the NFP, and the reserves or funds these assets and liabilities represent. Some asset values are included on the historical cost basis. This represents the cost of the asset, less depreciation or amortisation (the financial value representing economic consumption of the asset). Koala Ridge's assets included in property, plant and equipment are included on the historical cost basis, as set out in the extract of note 1 on page 25. The difference between the asset values between 20XB (\$181,342) and 20XC (\$159,058) is the depreciation charge of \$22,284 for 20XC presented in the statement of comprehensive income.

This also indicates no acquisitions or disposals of property, plant and equipment occurred during 20XC.

Other assets are included at fair value, which represents the market value that the NFP would obtain if it were to dispose of the asset at the year-end date. Liabilities are usually included at historical cost. Koala Ridge does not hold any assets or liabilities that are presented at their fair value.

Current assets are assets that the NFP expects to recover or realise within the following financial year. Non-current assets can normally be recovered or realised over a longer period, after more than one financial year. Some non-current assets are held with no intention to dispose of but to put to use in conducting the activities of the NFP. Physical assets such as property, plant and equipment are such assets. For example, the land a golf club owns and operates for the playing of golf by its members is likely to be held for a number of years by the club.

Financial assets can either be current assets (such as cash held at the bank) or non-current assets (such as long-term investments held for a return). Similarly, non-financial assets can either be current (such as inventories) or non-current (such as property). Liabilities are classified similarly and are presented as current and non-current liabilities on the statement of financial position.

The statement of financial position can provide useful insights into the financial strength of an NFP. The net assets (total assets less total

liabilities) of Koala Ridge amounted to \$298,844 in 20XC and \$214,818 in 20XB. Excluding non current assets and non current liabilities, the net current assets of Koala Ridge (current assets less current liabilities) are \$93,240 in 20XC and \$1,494 in 20XB. \$100,000 was received as a grant for a specific purpose during 20XC (note 5 on page 25). Excluding this, the net current liabilities for 20XC amounts to \$6,760.

In contrast to the statement of comprehensive income, the statement of cash flows presents the actual inflows and outflows of cash from the entity's various activities. Some of these cash flows will relate to income and expenditure for the year (for example grants received or salaries paid) whilst other cash flows relate to items in the statement of financial position (such as the acquisition of investments).

The statement of changes in equity presents the reserves (or funds) held by the NFP (in the form of assets and liabilities) to meet its objectives. The reserves can be presented individually in the statement of changes in equity, or alternatively a summary is presented in the statement, with further details provided in the notes. The statement shows the balances brought forward of the amount held in the reserves, the movements in and out during the year, and the balances carried forward. The movements include the surplus or deficits arising during the year and any transfers between funds during the year.

APPENDIX

EXAMPLE EXTRACTS FROM FINANCIAL STATEMENTS

KOALA RIDGE BEACH LIFE SAVERS INCORPORATED
STATEMENT OF COMPREHENSIVE INCOME FOR THE
YEAR ENDED 30 JUNE 20XC

	Note	20XC \$	20XB \$
Income			
Member fees		30,622	37,389
Fundraising appeals		50,842	61,111
Government and other grants	5	152,348	67,142
Donations		46,735	42,954
Beach cricket tournament collections		10,244	8,433
Subsidies		7,848	4,834
Bar income		4,223	4,782
Equipment hire		1,523	1,718
Gym fees		5,232	6,225
Hire of hall		39,422	38,284
Inventory sales		31,823	29,384
Dividends received		2,978	2,432
Interest received		2,534	3,628
Total income		386,374	308,316
Expenditure			
Fundraising expenses		31,111	42,342
Beach cricket tournament expenses		11,482	10,342
Bar expenses		5,924	4,848
Catering		10,721	8,777
Inventory purchases		15,423	14,284
Hall maintenance		29,842	27,482
Depreciation		22,284	20,342
Gas and electricity		12,423	11,484
Employee costs		99,836	90,145
Insurance		15,222	17,842
Motor vehicle expenses		2,224	3,897
Printing, postage and stationery		798	642
Repairs and maintenance		29,784	26,642
Security		3,484	3,121
Professional fees		7,824	7,523
Telephone		1,742	1,548
Loan interest		1,642	1,872
Bank charges		582	497
Total expenditure		302,348	293,630
Operating surplus/(deficit)		84,026	14,686

KOALA RIDGE BEACH LIFE SAVERS INCORPORATED
STATEMENT OF FINANCIAL POSITION FOR THE YEAR
ENDED 30 JUNE 20XC

	Note	20XC \$	20XB \$
Current assets			
Cash at bank		91,808	24,798
Inventories	2	6,434	5,884
Other assets		7,552	4,646
Total current assets		105,794	35,328
Non-current assets			
Property, plant and equipment	3	159,058	181,342
Investments	4	64,373	54,324
Total non-current assets		223,431	235,666
TOTAL ASSETS		329,225	270,994
Current liabilities			
Trade creditors		6,439	14,846
Other creditors		6,115	18,988
Total current liabilities		12,554	33,834
Non-current liabilities			
Bank loan		17,827	22,342
Total non-current liabilities		17,827	22,342
TOTAL LIABILITIES		30,381	56,176
NET ASSETS		298,844	214,818
Funds		298,844	241,818
TOTAL MEMBERS FUNDS		298,844	214,818

KOALA RIDGE BEACH LIFE SAVERS INCORPORATED
STATEMENT OF CHANGES IN FUNDS FOR THE YEAR
ENDED 30 JUNE 20XC

	General funds \$
Balance at 1 July 20XA	200,132
Operating surplus/(deficit)	14,686
Balance at 30 June 20XB	214,818
Operating surplus/(deficit)	84,026
Balance at 30 June 20XC	298,844

KOALA RIDGE BEACH LIFE SAVERS INCORPORATED
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED
30 JUNE 20XC

	20XC \$	20XB \$
Cash flows from operating activities		
Receipts from donations and gifts	46,937	43,590
Grant receipts	148,230	49,270
Fundraising receipts	50,842	61,111
Member and customer receipts	102,765	118,391
Dividend income	2,724	2,040
Interest income	2,642	3,506
Payments to suppliers and employees	(291,022)	(274,050)
Net cash flows from operating activities	63,118	3,858
Cash flows from investing activities		
Purchase of investments	15,481	6,441
Disposals of investments	(5,432)	(2,124)
Net cash flows from investing activities	10,049	4,317
Cash flows from financing activities		
Bank loan repayment	(6,157)	(5,724)
Net cash flows from financing activities	(6,157)	(5,724)
Net increase/(decrease) in cash and cash equivalents	67,010	2,451
Cash and cash equivalents at beginning of year	24,798	22,347
Cash and cash equivalents at end of year	91,808	24,798

KOALA RIDGE BEACH LIFE SAVERS INCORPORATED (EXTRACT OF) NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 20XC

NOTE 1: (EXTRACT OF) SIGNIFICANT ACCOUNTING POLICIES

Basis of preparation

The financial statements are prepared on the accruals basis and are based on historical cost. The financial statements are special purpose financial statements prepared in order to satisfy the requirements of the financial reporting requirements under the Associations Incorporation Act (QLD) 1981. In the opinion of the management committee, Koala Ridge is not a reporting entity because there are no users dependent on general purpose financial statements.

	20XC \$	20XB \$
NOTE 2: INVENTORIES		
Equipment for sale	6,232	5,248
Donated goods	202	636
	6,434	5,884

NOTE 3: PROPERTY, PLANT AND EQUIPMENT		
Freehold land and buildings	168,340	168,340
Less accumulated depreciation	(40,950)	(28,250)
	127,390	140,090
Equipment	36,402	36,402
Less accumulated depreciation	(12,851)	(7,351)
	23,551	29,051
Motor vehicles	17,550	17,550
Less accumulated depreciation	(9,433)	(5,349)
	8,117	12,201
Total property, plant and equipment	159,058	181,342

NOTE 4: INVESTMENTS		
Term deposits – fixed interest	42,382	42,382
Shares	21,991	11,942
	64,373	54,324

NOTE 5: GOVERNMENT AND OTHER GRANTS (EXTRACT)

Baywatch grant

During the year, Koala Ridge received a grant of \$100,000 from Hofferson Council. The council has stipulated that the grant should be used to provide themed uniforms to lifeguards and other support staff and volunteers, provide advanced training in life-saving skills to lifeguards and other support staff and volunteers, and to purchase life-saving equipment. As the grant was received in the final quarter of the year, Koala Ridge intends to commence fulfilling the grant requirements in the period commencing the second half of 20XD and intends to complete the activities in relation to the grant by the following year.

GLOSSARY

Accounting standards: Standards applied in preparing financial statements. In Australia, these standards are issued by the Australian Accounting Standards Board.

Assets: Items of value which the entity can trade or use to conduct its activities.

Assurance: The expression of a conclusion that is intended to increase the confidence of users in financial statements.

Audit report: The final report setting out the auditor's opinion.

Charity: A type of not-for-profit entity that conducts activities that are for the public benefit.

Constitution: The document that sets out the rules by which an entity should operate and the objectives of the entity.

Emphasis of matter: A paragraph included in the auditor or reviewer's report referring to a matter appropriately presented or disclosed in the financial statements, that in the auditor' or reviewer's judgement, is of such importance that it is fundamental to the user understanding of the financial statements.

Equity: Total assets less total liabilities, represented by accumulated reserves or funds.

Fair value: The monetary or financial value that an entity could obtain on the sale or disposal of an asset in an open market scenario.

Fundraising: Generating revenue through soliciting and gathering voluntary contributions.

Going concern assumption: The ability of the entity to continue to operate into the foreseeable future (usually a period of 12 months from the date the financial statements are approved).

Historical cost: The original monetary or financial value of an asset or item acquired by an entity.

Incorporated association: A type of not-for-profit entity formed under the incorporation laws of an Australian state or territory.

Impairment: A downward valuation of an asset when the carrying value exceeds the recoverable value of an asset.

Liabilities: Amounts which the entity is obliged to pay to others.

Liquidity: The ease with which assets can be converted into cash.

Loss/deficit: The excess of expenses over revenue.

Material misstatement: An inaccuracy or omission in the financial statements that is significant enough to affect the decisions made by users of the financial statements.

Modified opinion: A modification by the auditor or reviewer of their report that results in a qualified opinion, adverse opinion or disclaimer of opinion, or the addition of an emphasis of matter paragraph.

Profit/surplus: The excess of revenues over expenses.

Review report: The final report setting out the reviewer's opinion.

Solvent: An entity's capacity to continue to pay its debts as they fall due.

True and fair: Presenting an accurate and unbiased picture of an entity's financial position and performance in the financial statements.

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