Economia Aziendale Online

International Business Review

Financial Reporting and Sustainable Management

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SPECIAL ISSUE - SMOG Conference Proceedings

Pavia, July, 2010
N. 3 bis/2010
Summer Issue
www.ea2000.it
www.economiaaziendale.it

Pavia University Press

Electronic ISSN 1826-4719

Reg. Trib. Pavia n. 685/2007 R.S.P.

Economia Aziendale Online 2000 Web 3 bis Summer Issue (2010) - 253 - 260
www.ea2000.it

Financial Reporting and Sustainable Management

Matteo Pozzoli

Abstract

Accountability is crucial to Not-for-Profit-Organizations (NPOs) and Public Sector Entities. In this perspective, the Italian accountancy profession, represented, until 2007, by Consiglio Nazionale dei Dottori Commercialisti (CNDC) and Consiglio Nazionale dei Ragionieri (CNR), and since then by Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili, has played a significant role.
This paper specifically aims at illustrating the main accounting practices recognized by the Italian accounting profession with reference to the mentioned entities, not finalized to profit.
As far as NPOs are concerned, the CNDC had appointed an *ad hoc* "NPOs Committee", which enacted a set of accounting recommendations, intended to provide professionals and stakeholders with technical guidelines concerning financial and social reporting as well as audit procedures. These requirements – which can be adopted on a voluntary basis - are the first example, at a national level, of technical documents concerning NPOs.
This document illustrates both the current activities undertaken by CNDCEC and the expected future developments.
As to the Public Sector, the accountancy profession is an active member of the most authoritative local and international Boards. CNDCEC has thereby the possibility to give its contribution to the development of the International Public Sector Accounting Standards.
Some final considerations are dedicated to the role that financial and social reporting can play in the development of non-profit oriented entities.

Keywords: Reporting, Accounting Practices

Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.
WORLD COMMISSION ON ENVIRONMENT AND DEVELOPMENT (WCED), "Our common future", Brundtland Report (1987)

1 – Introduction

Adam Smith, one of the most influent economists and philosophers of the 18th century, affirmed that the maximization of the individual's utility represented the basic principle for the economic and social development of the population.

Business Economics academics have been debating about Corporate Social Responsibility (CSR) for fifty years, but only in the last decade has this subject become "popular" and considered crucial by professionals and other persons or institutions operating for the development of the "wealth of nations".

In general terms, the accountancy profession plays an active role in CSR's improvement. It is the single interest group which is more likely to be involved in adopting technical rules destined to provide a faithful representation of entities' management to external and internal stakeholders.

The accountancy profession takes an active role in the preparation of technical requirements at different levels.

Professionals provide their point of view while cooperating with regulatory authorities in the preparation of requirements concerning environmental issues, accounting representation of social events and assurance.

They spread out their own scientific and technical papers, stimulating public opinion to express a judgment regarding their point of view.

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In this context, many professional bodies have determined indicators and ratios necessary to measure the creation of social and environmental values, implementing criteria and tools as to "calculate" the level of effectiveness and efficiency of organisational management, controlling and monitoring fundraising operations.

By doing so, professionals can enhance the accountability and transparency of organisational management. By improving the organisation's accountability, the accountancy profession aims not only to increase the intelligibility of their reporting (external accountability), but also to clarify within its structure the skills and the opportunities unexpressed, supporting the decision-makers to bear the responsibility for their decisions – having a more complete set of information and considering the overall effect of their decisions – and to allocate in the most efficient way the available resources (internal accountability).

2 – The Accounting Practices for Not-for-Profit Organizations

2.1 – *The Recommendations enacted by the Not-for-Profit Organizations' Committee*

Civil law jurisdictions – such as the Italian one – usually provide basic requirements so that legal provisions alone are insufficient to guarantee a fair implementation. In this perspective, the accountancy profession covers a critical position in application guidance development in order to interpret legal rules, where they are ambiguous, or integrate them, if they are lacking.

The *Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili* (hereinafter "CNDCEC", formed through the merger of the two previous professional bodies representing the Italian accountancy profession), has been working to create tools to support a sustainable and conscious organisational management.

The CNDCEC's activity follows the innovative work already done by the former Consiglio Nazionale dei Dottori Commercialisti (hereinafter "CNDC") and Consiglio Nazionale dei Ragionieri (CNR).

More specifically, as far as Not for Profit Organizations (NPOs) are concerned, during the first decade of 21th century the "NPOs Committee" of CNDC enacted the accounting practices for NPOs which represented, given the profound lack of legislative rules, the benchmark for the organisations operating in the third sector.

These documents have been translated, exported and discussed in other countries. Table 1 represents the published accounting recommendations between 2000-2007 (CNDC). It should be highlighted that the NPO's Committee has focused its activities not only upon financial reporting issues, but also upon social reporting and external and internal audits.

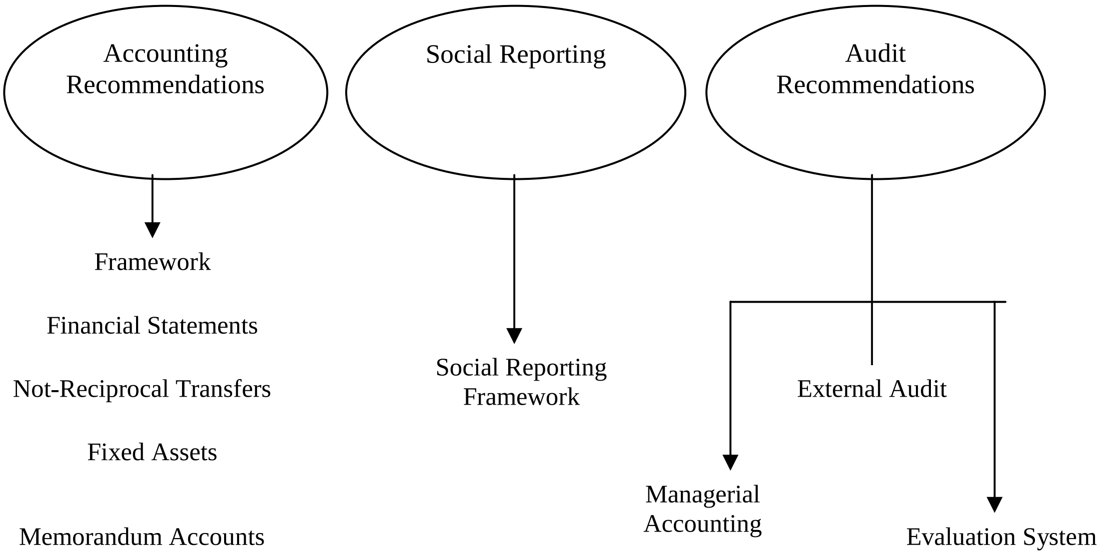
Table 1 – Recommendations enacted by the Not-for-Profit Organizations Committee (2000-2007)

Systematic Overview for Preparation and Presentation of the Financial Statements for Not For Profit Organizations
Recommendation No. 1 - Document Presenting a Representative System for the Performance Summary of Not For Profit Organizations
Recommendation No. 2 - Measuring and Carrying out Gifts in the Financial Statements of Not For Profit Organizations
Recommendation No. 3 - Notes to the Financial Statements and Mission Statement
Recommendation No. 4 - Statement of Changes in Equity
Recommendation No. 5 - Control Systems and Procedures in Not For Profit Organizations
Recommendation No. 6 - Fixed Assets
Recommendation No. 7 - The Social Report in Not For Profit Organizations: General Principles and Guidelines for Adoption
Recommendation No. 8 - Memorandum Accounts
Recommendation No. 9 - Group Financial Statements
Recommendation No. 10 - Performance Ratios and Indicators for Not For Profit Organizations Engaged in Fundraising and Receiving Grants from Public and Private Donors

In short, as far as social reporting is concerned, the NPO’s Committee enacted a specific “Recommendation” dedicated to social reporting. This has been addressed to the Italian professionals and organisations and has become the main reference standard. With specific reference to the external audit issues, it determined the general guidelines which should be adopted in external audits and offered a checklist for the social and economic management analysis of NPOs.

Having said that, we will dedicate our attention on the financial reporting activity, which has represented the “core business” of the Committee since its inception (see Table 2).

Table 2 – Classification of NPOs Committee Recommendations



The accounting Recommendations define a set of technical rules destined to NPOs, which do not have *ad hoc* rules. For instance, bank foundations or social cooperatives are NPOs and are obliged by an act to apply specific rules: it is clear that they can adopt NPOs’ Committee technical rules only when they do not conflict with their legislative requirements.

2.2 – *General guidelines of Not-for-Profit Recommendations*

Accounting recommendations are based upon the best practices of the third sector. Each document starts from an international analysis of the consolidated practices in the private and public sector.

More in detail, the Committee has taken into consideration national accounting principles for organizations and the principles issued for non-economic government agencies and local agencies. Furthermore, it usually addressed the International Financial Reporting Standards (IAS/IFRS) and the International Public Sector Accounting Standards (IPSAS)[1] and the US Generally Accepted Accounting Principles, with particular reference to the documents concerning not-for profit organisations (FASB, 1993a, 1993b), have been taken into consideration as internationally accepted accounting principles.

This is the reason the Accounting recommendation system represents an open model:

[1] In this regard, it is hereby specified that IFRSs refer to the International Financial Reporting Standards issued by the International Accounting Standards Board (IASB), while IPSAS refers to the International Public Sector Accounting Standards enacted by the International Public Sector Accounting Standards Board (IPSASB). The former became part of our national standards because Community Regulation 1606/2002, published in the Official Gazette of the European Union, foresees their compulsory use when preparing consolidated financial statements for organizations listed on one of the regulated community stock exchanges, while the latter are already used by supranational organisations (UN) or will be used in the near future (European Union).

whereas operators and users can not find a specific rule in the enacted rules, they should look for an appropriate solution in the aforementioned rules.

Furthermore, the Committee defines a hierarchy of references in accordance with the consolidated practice of local and international standard setters. More specifically, where recommendations do not deal with a specific event, operation or circumstance relating to fixed, a reference should be made in descending hierarchical order to the following sources:

– the Framework for preparation and presentation of the financial statements for Not-for-Profit Organizations;
– National Accounting Standards for private sector enacted, formerly, by the "Commissione per la statuizione dei principi contabili" of the Consigli Nazionali dei Dottori Commercialisti e dei Ragionieri (CNDC&R) and now by the Organismo Italiano di Contabilità;
– International Accounting Standards/International Financial Reporting Standards enacted by the International Accounting Standards Committee/International Accounting Standards Board;
– national and international accounting practice and literature specifically relating to not for profit organizations.

The above mentioned Framework provides preparers and users with general guidelines underlying the preparation and preparation of annual financial statements.

It is essentially based upon the original structure of the IASB's Framework, as reviewed and located into the third sector context.

The Framework identifies and investigates the main stakeholders' information needs (see Table 3). This is the starting point of the Committee's activity, because it examines the needs of the financial statements receivers and their expectations.

Table 3 – Identification and definition of NPOs' stakeholders (Framework, §18)

18. […] the recipients of the NPO financial statements can be divided into the following categories: ... a) *Supporters* – those who contribute their own resources (financial, economic, equity or personal) to help the organisation's "mission" can use the financial statements to obtain information allowing them to express judgement on the NPO's actions; this information may relate, from a quantitative point of view, to proper use of the resources provided and, from a qualitative point of view, to the results achieved. b) *Those benefiting from organization activities* – the individuals benefiting from the activities of the NPO (for example those receiving care, assistance, help in difficulty and all those receiving direct advantages/help from the organisation's activities) are interested in how the organisation is managed, as are those who shall carry out particular activities in order to achieve the results the NPO wishes to achieve (e.g.: researchers, artists, architects, etc.). These persons require information of a mainly qualitative nature; their principle expectations in terms of information therefore relate to the presence of data and information on the activities carried out, the results achieved and the forecasts for future activity. c) *Internal operators* – those who have a function "inside" the organization's organisation, such as NPO administrators, managers and/or workers, sometimes have specific information needs. In particular, the operators are interested, along with the information highlighted above, in receiving news on overall activities, so as to verify whether or not organization conduct is in line with the NPO's strategic aims. Finally, this category is also interested in economic and financial information, so as to evaluate what guarantee there is that their current activities will continue to be remunerated. d) *Customers, suppliers and financiers* – all subjects whose relationship with the NPO involve economic and financial exchange, such as creditors, commercial partners (suppliers and commercial customers) and financial creditors (lenders), as in the case of normal enterprises, require the financial statements to provide information of a prevalently economic and financial nature. For example, creditors are interested in understanding, from the quantitative data on the face of the accounts, whether or not the NPO is able to fulfil its obligations within the due times; commercial customers, on the other hand (for example a school that makes use of a printing facility started up to recover social misfits), will need to understand whether or not they will be able to continue to rely on this organisation in the future.

e) *Reference community* – all those "representing" the community (opinion leaders, public authorities, politics) are generically interested in actual productivity in terms of social utility and financial results.

f) *Public administration* – The Public Administration is interested in the action of NPOs and the consequent economic results both as regards tax benefits and as regards the supply activities, so as to verify proper use of the resources provided.

The other essential section of the Framework is related to the exposition and illustration of the information's qualitative characteristics. They are substantially consistent with the general requirements of the internationally accepted practice. However, the Committee's framework naturally diverges in some significant elements and first of all, it includes some technicalities with specific reference to the accrual basis of accounting.

NPOs should – in the Committee's perspective – apply the accrual basis of accounting. Only small NPOs could adopt a monetary basis of accounting, whereas it is able to represent the entity's "health" and NPOs can obtain economic benefits from this decision[2].

As far as the aforementioned adoption of the accrual basis of accounting, the Framework affirms that "the financial statements drawn up on an accrual basis are the ones best suited to provide information on the actual state of health of the business, with reference to the financial position and economic situation." (Framework, §33).

However, the accrual basis of accounting is not finalized to present the profitability of a business, as NPOs should not usually undertake commercial operations and in many cases, there is no link between income and expenses (matching principle). This statement has been the basis for many decisions taken in accounting for operations and items such as not-reciprocal transfers and fixed assets.

In technical terms, when it is possible to recover a synallagmatic operation, the principle adopted in "usual circumstances" by for-profit entities becomes fully applicable and direct reference has to be made to it [3].

If there is no direct link between income and expenses, costs should be determined in relation to the income produced.

That said, the Framework establishes a set of general accounting principles for NPOs. Table 4 illustrates the framework of general principles

Once the accounting Framework is analyzed in brief terms, it is worth making some observations concerning financial statements.

In relation to this the Committee affirms that the minimum content of NPOs financial statements should include:

– *Balance Sheet*. It represents the entity's financial position. Its structure is based upon the format prepared for limited companies according to art. 2424 of the Civil Code, even if reviewed in order to present NPOs peculiarities. This means that assets should be essentially classified according to their function within the single entity and liabilities in relation to their economic reason. Investments and funds related to supplementary activities should be presented in separate columns;

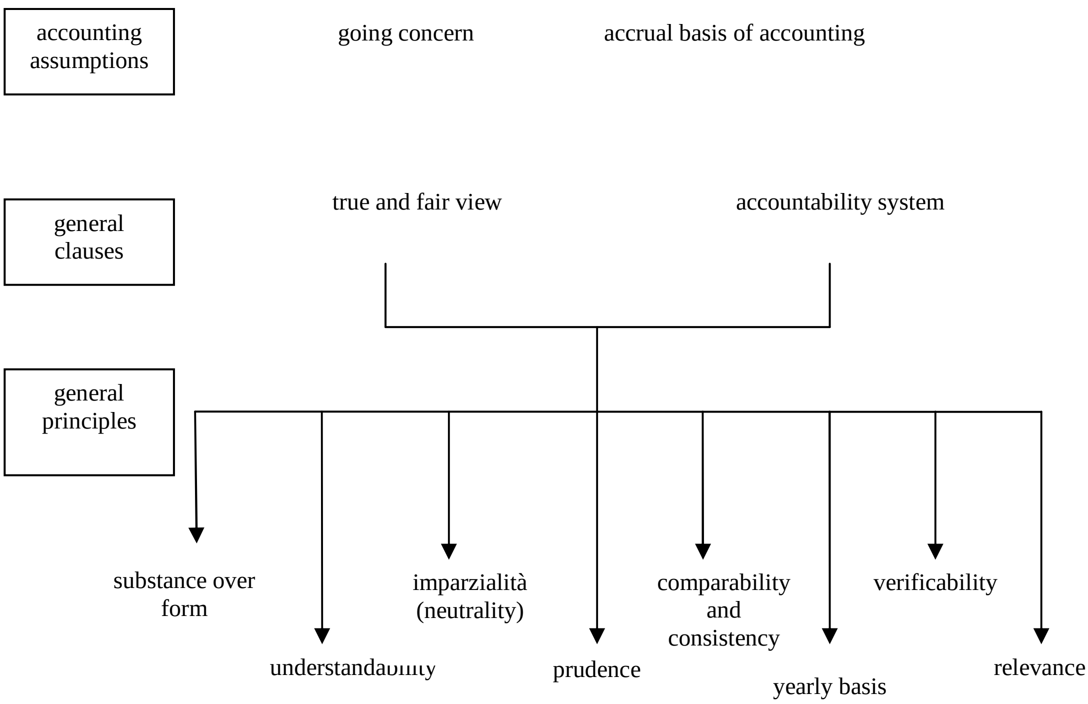
– *Statement of income and expenses*. It is oriented to "…represent the performance (positive or negative) for the period and to illustrate, by comparison of the revenue/income and costs/expenses, how the summary result was reached." (Recommendation n.1, §21). Income and expenses are carried out by individual and operating source for income and on classification by management function destination for expenses. Any classification of income and expenses by nature has to therefore be considered additional and not an alternative to classification by destination. The Committee recognizes the following managerial areas: typical or institutional activities: promotional and fundraising operations; supplementary activities: financial and equity operations; special activities; general support activities: The format is based on a two-sided presentation.

– *Notes*. They illustrate the content of the "numbers" included in quantitative statements. This section can be divided in: general information concerning the entity; general information concerning financial statements; information related to the financial position; information related to memorandum accounts; information illustrating the performance. The Recommendation n. 1 provides a general content of the notes, even if each technical Standard contains new requirements;

[2] Small NPOs are those NPOs whose overall annual income does not exceed 50,000 Euros for the two years preceding the reference period. They can apply the use of a simplified format for representation of the summary results. This threshold has been determined in the 2001 and it is a quantitative reference. At today, it should be reviewed in order to represent the money value.

[3] In this view, the main reference for the limited commercial operations undertaken by NPOs is the article 2426 of the national civil code and the related Italian accounting standards.

Table 4 – General principles



Adapted from: M. Pozzoli, Principi contabili per il terzo settore, Milano, Franco Angeli, 2009.

- *Statement of changes in equity*. It summarises the changes in items in the equity and articulate the use of resources according to the various restrictions that are in place. This statement is crucial for financial statements' users; as it explains the destination and the use of "restricted" and "unrestricted" funds;

- *Mission Statement*. It identifies the mission, the identity and the vision of the NPO by a a series of accounting and non-accounting details. It is not alternative to the preparation of other separate social reporting.

The Committee enacted an innovative Recommendation regarding the consolidated financial statements as well. This Recommendation analyzes the complex issue of the definition of the consolidation area of NPOs and has stimulated an interesting professional debate.

This paper is not the context to investigate in an exhaustive manner the technical requirements concerning the accounting for specific events, circumstances or operations. However, it is worth remembering that the Committee has published specific technical requirements in relation to not-reciprocal transfers and fixed assets.

At the same time, the CNR's Not-for-Profit entities' Committee has prepared an interesting technical document dedicated to the accounting for not-reciprocal transfers (CNR, 2002).

3 – Current Activities

The merger of CNDC and CNR into CNDCEC in 2008 gave the Italian accounting profession the opportunity to address the "state of the art" and to reschedule its activities with regard to mission-driven entities.

Three Committees have been established to address different aspects of NPOs. The "Financial and Management Reporting Committee" deals with issues regarding the NPOs' accounting disclosures.

The "Social Reporting Committee" develops guidelines focused on social accountability.

Last, the "Legislative and 'Impresa Sociale's' Analysis Committee" aims at providing tools for the proper application of the relevant rules. As a result of its work, the Committee addressed a specific booklet to the social enterprises (imprese sociali) dealing with the issues regarding social reporting, in July 2009 (CNDCEC, 2009). This booklet takes in account criticalities regarding governance, social and financial statements, and taxes.

It is important to highlight that CNDCEC signed a significant agreement with Organismo Italiano di Contabilità and Agenzia per le Onlus, the Italian organization dedicated to oversight over NPOs finalized to the social utility, in order to prepare the Italian Accounting Standards for NPOs.

This operation creates a new scenario in the Italian context, as NPOs will be able for the first time to prepare their financial statements in compliance with generally accepted accounting standards.

4 – The Accounting Practices for the Public Sector

The accountancy profession expended a significant effort in the development of the public sector entities financial and social reporting as well. CNDCEC takes part in institutional national committees (such as the "*Osservatorio per la Finanza e la Contabilità degli Enti Locali*") and international boards (i.e. IPSASB) and contributes to develop accountability guidelines specifically addressed to the Healthcare, Education and Public Sectors, through *ad hoc* committees.

The Osservatorio prepares the Italian accounting standards for local entities. It is instituted by the law and its members are appointed by the Minister of Interior.

It is important to highlight that the standards, even if they are not mandatory, are recognised by the above mentioned decree. The Osservatorio enacts standards concerning local entities' financial reporting. Furthermore, it decided to address the Recommendation to local entities' social reporting (Osservatorio, 2007).

The Italian accounting standards for local entities are important, because they propose a managerial interpretation of local entities' accountancy. Until some years ago, the local entities' accounting has been essentially interpreted as an administrative issue finalized to determine the available resources and, consequently, the needed funds. Budgets have been the most significant statements and financial reporting has been addressed as a mere obligation. The Osservatorio revaluated the "original" function of accounting, giving a more relevant function to the accrual basis of accounting, in order to enhance the transparency of financial management by local entities.

To underline the importance that the accounting profession attributes to social reporting, it is appropriate to highlight that in 2007 the CNDCEC edited its own first annual social report and that the CNDCEC is, at today, preparing its social report.

However, it is essential to acknowledge and remark that most of the sensitive sustainability issues need to be addressed in a proper perspective, wider than the regional one; it's not surprising that, starting from the 90s', international organizations such as UN, OECD and the European Union have supported the preparation of guidelines concerning the adoption of standardized models aiming at achieving comparability in the presentation of the performances of entities operating in different economic contexts, political environments and legislative frameworks.

As far as professionals and their activities are concerned, this field represents a new opportunity and a chance to increase their awareness, because it urges the accountancy profession to cover subjects which were not previously addressed.

In this context, the new challenge should focus on the potential ability of the accountancy profession to monitor the fair development of entities, providing sustainability reporting assurance standards, supporting the development of managerial and organizational efficiency and effectiveness sustainability indicators, and enhancing benchmarking and entities rating, in order to provide consumers, investors and other stakeholders with tools to support, monitor and guarantee a fair and sustainable management of the available resources.

5 – Conclusive Observations

The accounting practice for NPOs and public entities have changed greatly over the last years. This is due also to the professionals' activity.

Accounting professionals can contribute to the development of these technical issues, as they are likely the most involved stakeholders and can define appropriate and updated tools to give a faithful representation of these specific kinds of entities.

Proposals oriented to increase the role of accrual basis of accounting in NPOs and local entities are a meaningful example of a professional activity useful to pursue public interests.

Each entity needs to be managed as an organization able to be a going concern in the medium-long term. This does not necessarily mean they have to be profitable or self financing. They operate in non-profitable sectors and, in the most of the cases, need to be funded, but at the same time they pursue public interests and manage resources destined to pursue these objectives.

In this view, they are obliged to be as much effective and efficient as they can. Financial statements represent their way to "reddere conta" (to report) their management. NPOs and public sector entities support their activity by enhancing their financial statements transparency.

The accountable management of resources in NPOs and local entities can support the development of a community, and professionals have the knowledge to support this process.

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