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Dear Sir

Financial Reporting by Unlisted Public Companies

Philanthropy Australia welcomes the opportunity to comment on Treasury's June 2007 Discussion Paper *Financial Reporting by Unlisted Public Companies*.

Philanthropy Australia is the national peak body for philanthropy and is a non-profit membership organisation. Our members are trusts and foundations, families and individuals who want to make a difference through their own philanthropy and to encourage others to become philanthropists. Philanthropy Australia supports the philanthropic endeavour of our members by, amongst other things, promoting strong and transparent governance standards in the philanthropic sector. Our commentary on the Discussion Paper is one part of this activity.

The majority of Philanthropy Australia's members are involved in the provision of funds for charitable purposes. When allocating their funds our members consider the financial viability and governance of the recipient, often, at least in part, through assessing the information provided in the recipient's financial report. Philanthropy Australia's members are also acutely aware of the administrative burden placed on charitable not-for-profit companies limited by guarantee by Australia's current financial reporting regime.

The following commentary therefore seeks to achieve a balance between the information needs of our members and the burden placed on charitable not-for-profit companies limited by guarantee when providing that information.

All not-for-profit companies limited by guarantee enjoy exemption from income tax and also benefit from their limited liability status. Philanthropy Australia holds the view that these privileges render not-for-profit companies limited by guarantee accountable to the Australian community. The preparation of a financial report, accessible by interested members of the community, is one means of discharging this accountability and the accountability owed to other stakeholders.

With these broad issues of information needs, administrative burdens and accountability in mind, Philanthropy Australia takes this opportunity to suggest a pathway to a simplified, consistent reporting regime for charitable not-for-profit entities, including those incorporated under the *Corporations Act 2001*, the various *State Associations Incorporations Acts*, trust deeds, organisation specific legislation and even Royal Charters.

This pathway starts with the removal of the hurdle created by the definition of a public company in Section 9 of the *Corporations Act 2001*. This definition renders all

companies limited by guarantee "public companies" and obliges them to prepare a general purpose financial report that complies with accounting standards. This obligation creates a compliance burden many companies limited by guarantee, particularly those established for charitable purposes, find onerous.

Philanthropy Australia believes this hurdle should be removed by a change to the *Corporations Act 2001* that removes companies limited by guarantee from the definition of a public company and reserves this category of company for the incorporation of organisations that do not have a profit motive.

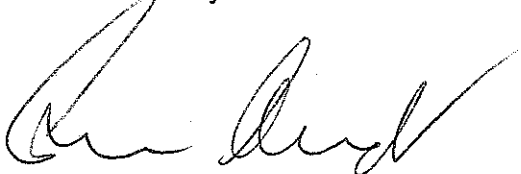
Having removed the hurdle, Philanthropy Australia recommends the Commonwealth work with the States to develop and promulgate a not-for-profit financial reporting regime that allows for differential financial reporting based on assets, revenue and the level of public accountability expected of the not-for-profit. We emphasise that we recommend a separate not-for-profit financial reporting regime, not the inclusion of specific "not-for-profit" paragraphs in Accounting Standards developed on a sector neutral basis. This includes any *IFRS for Small and Medium-sized Entities*. Ideally, a not-for-profit financial reporting regime would differentiate between not-for-profits established for charitable purposes and those established for community purposes such as sporting clubs, private clubs and membership services organisations.

Why involve the States? Philanthropy Australia believes Australia needs a consistent financial reporting regime for all not-for-profits, regardless of their basis of incorporation. Involving the States in the development of the not-for-profit financial reporting regime will result in a regime that the States can mandate through their *Associations Incorporations* legislation. In addition, by incorporating the financial reporting requirements presently included in the States' charitable fundraising legislation in the not-for-profit financial reporting regime, consistent disclosure of information such as the ratio of fundraising costs to funds raised will be achieved.

We believe that a combination of a consistent financial reporting regime for all not-for-profits and an annual reporting regime that will assist charitable not-for-profits to explain what they are trying to do and how they are going about it will result in a more transparent and accountable charitable not-for-profit sector.

Philanthropy Australia trusts you find our commentary on the issue raised in the Discussion Paper useful and look forward to discussing these responses with you.

Yours faithfully



Gina Anderson
Chief Executive Officer.

Issue for Comment A

Do you support the introduction of a differential reporting regime based on size for companies limited by guarantee? If so, what do you consider to be the appropriate criteria (both in terms of the indicators of size and the quantum of those indicators) for differentiating between those companies that are required to report and those companies that are exempt?

Philanthropy Australia supports the introduction of a differential reporting regime for companies limited by guarantee. We believe that the majority of these companies operating in the not-for-profit sector are presently burdened with a reporting regime that is disproportionate to the size and nature of their operations.

In addition, these companies suffer from a disadvantage when compared to incorporated associations because the legislation that governs associations already allows for differential financial reporting on the basis of revenue and assets. This disadvantage results in companies limited by guarantee incurring additional compliance costs.

We have reviewed *Request for Comment on a Proposed Revised Differential Reporting Regime for Australia and IASB Exposure Draft of A Proposed IFRS for Small and Medium-sized Entities* issued by the Australian Accounting Standards Board (AASB) in May 2007 (ITC12).

ITC12 includes the following:

Under the proposed revised differential reporting regime, Australian Accounting Standards would apply to not-for-profit private sector entities that prepare general purpose financial reports. The AASB acknowledges that, on cost-benefit grounds, there is a case for differential reporting in this sector. The AASB's preliminary view is that size thresholds should be applied to not-for-profit private sector entities that prepare general purpose financial reports so that:

- a) not-for-profit private sector entities exceeding either of two size thresholds would apply Australian equivalents to IFRSs; and*
- b) not-for-profit private sector entities that fall under the two size thresholds would apply an Australian equivalent to the IFRS for SMEs (which would include Aus paragraphs similar to those included in Australian equivalents to IFRSs). Such entities could also choose to apply the full set of Australian equivalents to IFRSs.*

The following thresholds are proposed:

- Consolidated Revenue for the financial year of the entity and the entities it controls (if any) – \$25m; and*
- Consolidated Assets at the end of the financial year of the entity and the entities it controls (if any) – \$12.5m*

Philanthropy Australia supports the broad thrust of ITC12 and the thresholds suggested in that document.

Our support for the suggested thresholds is engendered by Table 1 in the Discussion Paper. If the thresholds in ITC12 were to be adopted, 98% of companies limited by guarantee would be able to apply the differential reporting set out in the *IASB Exposure Draft of A Proposed IFRS for Small and Medium-sized Entities*.

We have some reservations regarding the differential reporting regime proposed in ITC12 and will be bringing those to the attention of the AASB. In particular, we believe that, should the *IASB Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities* be adopted without amendment to require fewer disclosures, there will be a need for a third tier of simpler reporting requirements for smaller not-

for-profit entities. We are pleased to note that the AASB acknowledges there “*may be a need for [such] a third tier.*”

If the *IASB Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities* is to be the basis of a harmonised, consistent not-for-profit reporting regime that applies to both companies limited by guarantee and incorporated associations, a third tier will be necessary. We believe the current thresholds that differentiate small and large proprietary companies would be appropriate to separate the third tier from other not-for-profit entities. That is, any not-for-profit entity that has less than \$10 million gross operating revenue in a year and assets of less than \$5 million at the end of the financial year would fall into the third tier.

Issue for Comment B

Do you believe it is appropriate to differentiate between companies limited by guarantee by the nature of their operations rather than just size? If so, what nature of operations do you believe warrants greater transparency?

Philanthropy Australia believes it is appropriate to differentiate between not-for-profit companies limited by guarantee by the nature of their operations rather than just size. We recommend that not-for-profit companies limited by guarantee that are *publicly accountable* should display a greater degree of transparency through their reporting. This requires examination of what constitutes *public accountability*.

ITC 12 makes reference to the concept of *public accountability* as the basis for differentiation between entities that should apply full IFRS reporting and those that can apply the IFRS for SMEs.

Unfortunately the IASB’s definition of *public accountability* is limited to for-profit entities. ITC12 notes:

“According to the IASB’s definition, an entity has public accountability if:

- a) it files, or it is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; or*
- b) it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance entity, securities broker/dealer, pension fund, mutual fund or investment banking entity.*

Clearly, not-for-profit companies limited by guarantee do not issue instruments in a public market or act in a fiduciary capacity as contemplated in ITC12. However, not-for-profit companies limited by guarantee do have a different group of stakeholders and attributes that might result in them being *publicly accountable*. The following matrix provides an indication of the degree of *public accountability* that can be ascribed to a not-for-profit company limited by guarantee based on the company’s operations. Differentiating between not-for-profit companies limited by guarantee on the basis of operations will require consideration of a number of the attributes set out in this matrix.

The public accountability matrix

| | | Level of Public Accountability (High, Medium Low) |
|------------------------|--|--|
| Source of funds | Public appeals for donations | High |
| | Solicits for & receives bequests | High |
| | Government grants | High |
| | Grants from foundations | Medium |
| | Sponsorships | Medium |
| Membership | One individual, family or corporation | Low |
| | Widespread geographically | High |
| | Management and membership separate | High |
| Volunteers & employees | Majority of members actively involved in day-to-day management | Low |
| | High level of reliance on volunteers to achieve objectives; few if any employees | High |
| Other | Objectives achieved by employees; little volunteer involvement | Medium |
| | Many stakeholders | High |
| | Income tax exemption | Low to Medium |
| | Few stakeholders other than members | Low to Medium |
| | Operate Australia wide and/or internationally | High |
| | Operate in limited geographic area (one suburb or country town) | Low to Medium |
| | Significant community impact | High |
| | Impact limited to a specific community or one group within a community | Low to Medium |
| | Represents a number of communities or affiliated bodies | High |

Issue for Comment C

Do you consider that companies limited by guarantee that receive any money through grants should have financial reporting requirements? If so, can this obligation be satisfied by the company providing special purpose financial reports to the grantor rather than preparing general purpose financial reports under the Corporations Act?

Philanthropy Australia considers that not-for-profit companies limited by guarantee in receipt of grants, whether from government or private sources, should have financial reporting requirements. As noted in our covering letter, Philanthropy Australia recommends a separate not-for-profit financial reporting regime, not the inclusion of specific "not-for-profit" paragraphs in Accounting Standards developed on a sector neutral basis. This includes any *IFRS for Small and Medium-sized Entities*. Ideally, a not-for-profit financial reporting regime would differentiate between not-for-profits established for charitable purposes and those established for community purposes such as sporting clubs, private clubs and membership services organisations. It should satisfy the requirements of grantors.

If grantors require additional information, this can be obtained from acquittal certificates which are, in effect, special purpose financial reports prepared to meet the specific needs of the grantor. As an aside, our members have advised us that there is a wide variance in the form and content of acquittal certificates required by grantors. The not-for-profit sector would benefit from reduced compliance costs if grantors, particularly Federal, State and Local governments, could agree on a standard format of acquittal certificate.

The following table summarises Philanthropy Australia's suggested approach to financial reporting by the not-for-profit sector.

| <u>Form of reporting</u> | <u>Revenue</u> | <u>Assets</u> | <u>Public Accountability</u> |
|---|-----------------------------------|-----------------------------------|---|
| Tier 1: Compliance with all relevant requirements of <i>IFRS for Not-For-Profits</i> for this tier | > \$25 million | > \$12.5 million | When a not-for-profit has revenue and assets of these amounts it can be assumed it will have a high level of <i>public accountability</i> |
| Tier 2: Compliance with all relevant requirements of <i>IFRS for Not-For-Profits</i> for this tier | > \$10 million but < \$25 Million | > \$5 million but < \$12.5Million | The level of disclosure in the financial report varies according to the level of <i>public accountability</i> of the entity |
| Tier 3: Compliance with all relevant requirements of <i>IFRS for Not-For-Profits</i> for this tier | \$10 million or less | \$5 million or less | |

Issue for Comment D

If you support some companies limited by guarantee being exempted from financial reporting, what percentage of members should be required in order to require an exempt company limited by guarantee to prepare a financial report?

Philanthropy Australia does not support some not-for-profit companies limited by guarantee being exempted from financial reporting. We believe that the reporting regime summarised under *Issue for comment C* provides sufficient scope for financial reporting to stakeholders that achieves the right balance between transparency and cost of compliance.

Issue for Comment E

If you support the retention of financial reporting requirements for all companies limited by guarantee, do you consider that there is scope to reduce the amount of financial information these companies are required to report? If so, what type of financial information do users need companies limited by guarantee to report (for example, related-party disclosures)?

What information is needed by the users of financial reports produced by not-for-profit companies limited by guarantee? Not-for-profit stakeholders are more likely to be interested in *“what a [not-for-profit] is trying to do and how it is going about it”* rather than extensive financial information. Our comment is therefore made in the context of Philanthropy Australia's view that financial reports do not completely explain the results of a not-for-profit's operations. This view is best expressed by the United Kingdom Charity Commission, which has noted:

“Charity accounts alone do not meet all the information needs of users who will usually have to supplement the information they obtain from the accounts with information from other sources.

Accounts also have inherent limitations in terms of their ability to reflect the full impact of transactions or activities undertaken and do not provide information on matters such as structures, governance and management arrangements adopted by a charity. The accounts of a charity cannot alone easily portray what the charity has done (its outputs) or achieved (its outcomes) or what difference it has made (its impact). This is mainly because

many of these areas cannot be measured in monetary terms: indeed some areas are difficult to measure with any numbers at all. The ... Annual Report provides the opportunity for charity [Boards] to explain the areas that the accounts do not explain.

Charity accounts should therefore be accompanied and complemented by information contained within the ... Annual Report. The ... Annual Report should be a coherent document that meets the requirements of law and regulation and provides a fair review of the charity's structure, aims, objectives, activities and performance. Good reporting will explain what the charity is trying to do and how it is going about it. It will assist the user of accounts in addressing the progress made by the charity against its objectives for the year and in understanding its plans for the future. Good reporting will also explain the charity's governance and management structure and enable the reader to understand how the numerical part of the accounts relates to the organisational structure and activities of the charity.¹

ITC12 includes a suggested Disclosure Checklist to assist SMEs in implementing the proposed *IFRS for Small and Medium-sized Entities*. This checklist extends to 53 pages. If not-for-profit companies limited by guarantee are expected to comply with this proposed Standard and then explain "what a [not-for-profit] is trying to do and how it is going about it" – the information stakeholders are really seeking – then the cost of annual reporting by not-for-profit companies limited by guarantee is more likely to stabilise rather than decrease.

The size of the checklist also indicates the AASB will need to provide extensive guidance regarding the application of this proposed Standard to two (or possibly three) tiers of not-for-profit companies limited by guarantee.

Philanthropy Australia will be preparing a detailed response to ITC12 setting out recommended minimum disclosures to be included in the financial reports of not-for-profit companies limited by guarantee.

Issue for Comment F

Do you consider that there is a need to harmonise the financial reporting requirements of companies limited by guarantee and incorporated associations to provide a consistent reporting framework for not-for-profit entities in Australia?

Philanthropy Australia supports the introduction of harmonised, consistent financial reporting requirements for not-for-profit entities, no matter what the basis of their incorporation. This support is based on a desire to ensure the reporting regime for not-for-profits is as simple as possible. Philanthropy Australia believes that a harmonised, consistent financial reporting regime should satisfy the financial reporting requirements of the *Corporations Act 2001*, the various *Associations Incorporation Acts* and State and Territory fundraising legislation.

Appendix 1 attached to the Discussion Paper, which summarises the financial reporting requirements for unlisted public companies and incorporated associations, provides some indication of the complexity of the reporting regime that presently applies to Australian not-for-profits.

This current complexity is exacerbated by:

¹ SORP, 'Accounting & Reporting by Charities: Statement of Recommended Practice', United Kingdom Charity Commission, 2005. Copies of the document can be downloaded www.charity-commission.gov.uk

- the need for a not-for-profit to decide whether it is a reporting entity or not;
- the need to decide what is to be included in the financial report (be it general purpose or special purpose) to ensure compliance with accounting standards; and
- specific reporting requirements of fundraising legislation, particularly in New South Wales.

More recently, the decision by the Australian Accounting Standards Board (AASB) to continue to make transaction neutral accounting standards that generally apply to both for-profit and not-for-profit entities when introducing International Financial Reporting Standards (IFRS) in Australia has added a further element of complexity to the not-for-profit reporting regime.

It should also be noted that there are instances of Incorporated Associations that operate beyond the State in which they are incorporated. One example of such an Association is the Australian Conservation Foundation, which is incorporated under the *Associations Incorporation Act (ACT) 1991*, has its principal place of business in Carlton, Victoria and offices in Sydney, Adelaide and Cairns. Appendix 1 attached to the Discussion Paper indicates the differences between the financial reporting regimes that operate in the ACT and Victoria.

Issue for Comment G

In order to assist in progressing this project, it would be useful to obtain an indication from companies limited by guarantee of the cost of preparing a directors' report and audited financial report as required by the Corporations Act.

Philanthropy Australia is unable to assist in this matter as there has been inadequate time available to gather the information from our members. .

Issue for Comment H

If some companies limited by guarantee were to be exempt from financial reporting, do you consider there is value in these companies continuing to be subject to some level of non-statutory external assurance as a means of promoting good governance? If so, what should this assurance relate to and how do you think this regime should be introduced (for example, through best practice guidelines issued by the professional accounting bodies)?

There are a number of issues arising from this *Issue for comment*.

We are asked to consider whether there is value in these companies – rather than their financial reports – continuing to be subject to some level of non-statutory external assurance. The Institute of Internal Auditors defines assurance as “an objective examination of evidence for the purpose of providing an independent assessment on risk management, control, or governance processes for the organisation.” External assurance is provided by “a person or firm, outside of the organisation, who has special knowledge, skill, and experience in a particular discipline.”

We have considered how a regime of *non-statutory external assurance* that satisfies the definitions in the previous paragraph might be applied. In the absence of a requirement for a financial report, *non-statutory external assurance* might be provided in respect of the internal controls and/or governance processes of the “exempt” not-for-profit companies limited by guarantee. The need for such assurance would subject these entities to a form of assurance that other “non-exempt” entities would not be subject to. Philanthropy Australia does not support such a regime.

The use of the term “non-statutory” implies that “exempt” not-for-profit companies limited by guarantee would be expected to adopt a rule or code not found in a law, but which may have enforcement mechanisms attached.

If the *Issue for comment* is suggesting that “exempt” not-for-profit companies limited by guarantee are expected to comply with (for example) financial management and governance guidelines drawn up by the accounting bodies, this poses further questions:

- Would (or should) those guidelines apply to all not-for-profit companies limited by guarantee – both “exempt” and “non-exempt”?
- Who would provide the external assurance and how would the assurance be evidenced and made available to stakeholders?
- If it is intended that the assurance should be provided by the Directors of “exempt” not-for-profit companies limited by guarantee on a self-assessment basis, how would the assurance be evidenced and made available to stakeholders?

Philanthropy Australia believes that the three tier financial reporting regime suggested in our response to *Issue for comment C* obviates the need for “exempt” not-for-profit companies limited by guarantee and therefore the need for some level of non-statutory external assurance

Issue for Comment I

For those companies limited by guarantee that are required to prepare financial statements, do you consider that there is a need to change the current audit requirements? If so, which aspects of the current requirements need to be reformed?

Philanthropy Australia believes that the three tier financial reporting regime suggested in our response to *Issue for comment C* obviates the need for changes to the current audit requirements.

Issue for Comment J

Do you support amending the Corporations Act so that companies limited by guarantee are specifically prohibited from distributing profits to members in the form of dividends?

Philanthropy Australia supports such an amendment provided the amendment to the *Corporations Act 2001*:

- reserves this category of company for those entities carrying out activities with a not-for-profit objective; and
- includes the introduction of a not-for-profit financial reporting regime for these companies.

The Discussion Paper refers to a survey “by *The University of Melbourne* which found ... almost all companies limited by guarantee have a not-for-profit motive”. On this basis, our suggested amendments could be introduced with little impact on the approximately 11,000 companies limited by guarantee registered under the *Corporations Act 2001*.

Issue for Comment L

Given a satisfactory mechanism to allow unlisted public companies limited by shares with a not-for-profit objective to convert to a company limited by guarantee is not available, would you support an equivalent differential reporting regime to that proposed for companies limited by guarantee to be established for unlisted public companies limited by shares with a not-for-profit focus? If so, do you support using the definition of not-for-profit entity in the accounting standards to determine whether a company has a not-for-profit focus?

The Discussion Paper does not provide the number of unlisted public companies limited by shares with a not-for-profit focus. In principle, Philanthropy Australia supports the establishment of an equivalent differential reporting regime to that proposed for companies limited by guarantee for unlisted public companies limited by shares with a not-for-profit focus.

However, if the extension of differential reporting to unlisted public companies limited by shares with a not-for-profit focus is meant to provide an alternative form of incorporation for not-for-profit entities, we foresee administrative difficulties.

The most significant of these difficulties is ownership. Membership of a company limited by guarantee does not generally enable the member to transfer that membership for a consideration. In the absence of any restrictions, shares in an unlisted public companies limited by shares could be transferred for a consideration and potentially for a profit to the transferor.

Consider the situation where a not-for-profit unlisted public company limited by shares has established a commercial activity to fund its community work or provide employment for disadvantaged individuals. An unscrupulous member might acquire other members' shares and use that control to vote him or herself significant salaries or benefits. Differential reporting might permit the concealment of these benefits.

In addition, if it is intended to specifically prohibit companies limited by guarantee from distributing profits to members in the form of dividends, we believe that the same prohibition should apply to unlisted public companies limited by shares with a not-for-profit focus. This would add to administrative complexity.

As far the use of the definition of not-for-profit entity in the accounting standards to determine whether a company has a not-for-profit focus, we note this definition reads:

"A not-for-profit entity is an entity whose principal objective is not the generation of profit. A not-for-profit entity can be a single entity or a group of entities comprising the parent and each of the entities that it controls."

We also note that recently CPA Australia suggested the following more expansive definition of a not-for-profit entity, which we support:

"... an entity should be classified as a not-for-profit when:

- *that entity has operating purposes other than to provide goods and services at a profit*
- *no member/owner has the right to surpluses of the entity*
- *that entity does not have the right to transfer ownership to members/owners*
- *that entity does not have:*
 - i. *the objective of generating profit outlined in the entity's legislation, associated regulation or constitution, or other founding document;*
or
 - ii. *as its principal objective the generation of profit."*

Issue for Comment M

In order to assist in progressing this project, it would be useful to obtain an indication from unlisted public companies limited by shares of the cost of preparing a directors' report and audited financial report as required by the Corporations Act and also the number of unlisted public companies limited by shares that have a not-for-profit objective.

Philanthropy Australia is unable to assist in this matter as there has been inadequate time available to gather the information from our members. ...