



Public Interest Law Clearing House

14 August 2007

By email

The General Manager  
Corporations and Financial Services Division  
Department of the Treasury  
Langton Crescent  
PARKES ACT 2600

Dear Sir/Madam

**Submission – Financial Reporting of Unlisted Public Companies**

Thank you for the opportunity to make a submission on this issue. We commend the Parliamentary Secretary to the Treasurer, The Hon Chris Pearce, for initiating this review with the aim of reducing the regulatory burden for the not-for-profit (NFP) sector. The NFP sector plays a vital role in Australia's economic and social well being yet it is clear that the current regulatory framework for NFPs is complex and not well tailored to support the sector.

**1. PILCH**

By way of background, the Public Interest Law Clearing House (Vic) Inc. (PILCH) was established in 1994, and is an independent, community legal service. It seeks to meet the legal needs of Victorian-based NFP organisations, and individuals from disadvantaged or marginalised backgrounds by facilitating their access to pro bono legal assistance from PILCH members. Its main role is to receive, assess and refer requests for pro bono legal assistance. PILCH aims to work creatively to match clients with lawyers willing to give their services without charge.

In a typical year, about 100 NFPs are referred by PILCH for free legal advice. These NFPs vary greatly in size and type (eg, companies limited by guarantee and incorporated associations). Many are very small and not well-known. The range of legal issues is also diverse, although there are common requests that are NFP-specific (eg, what legal structure to adopt, eligibility for concessional tax status). Aside from those matters that lead to a referral, help is given by PILCH to more than 200 other organisations/groups each year: eg, defining the nature of their issue and connecting them to other services.

In March 2007, the PILCH Board resolved to establish a new specialist legal service for NFPs. We are currently seeking funding to establish this service. A key aspect of the new service is to become a hub of NFP legal and legally-related expertise. In this way, the new service would become a 'port of call' for government reviews such as the current review. For further information about the proposed service, see our 'Establishment of Not-for-Profit Legal Service Research Report':

[http://www.pilch.org.au/html/s02\\_article/article\\_view.asp?id=429&nav\\_cat\\_id=255&nav\\_top\\_id=66](http://www.pilch.org.au/html/s02_article/article_view.asp?id=429&nav_cat_id=255&nav_top_id=66)

## 2. Regulatory burden

As a general comment, it is clear from more than a decade of experience that NFPs, particularly smaller groups that are reliant on volunteers, find the NFP regulatory framework confusing and complex. Further, as part of our research into possible new services, we held a focus group of NFPs (see Research Report, heading 9.2) and the issue of regulatory complexity and fragmentation between Federal and State regimes was raised as a common concern.

PILCH urges the Federal government to work with the State governments to establish a nationally consistent regulatory regime for NFPs, including their public fundraising activities. Ideally, this should be implemented by way of a new Federal Act of Parliament rather than by a co-operative State-based scheme or amendment of the existing Corporations Act. PILCH also supports the establishment of a new, independent, specialist regulator for NFPs.

## 3. Feedback from Expert Think Tank

In order to respond to the Treasury Discussion Paper, PILCH organised an informal think tank of NFPs and practitioners (legal and accounting) with expertise in the area. As there was relatively short notice to hold the meeting, the group was an informal one, via our immediate networks. Several invitees were keen to attend but unable to – some have contributed via email. The think tank was held on 16 July and kindly hosted by our member firm, Clayton Utz. We had 14 participants including senior legal practitioners, representatives from the Law Institute of Victoria, a senior policy advisor from CPA Australia and representation from the National Roundtable of Nonprofit Organisations. The session was chaired by Mr Tony Lang, a barrister experienced in this area. There was active discussion about the Treasury Paper and also about the broader picture of the most appropriate NFP regulatory framework and regulator. This submission is not a submission on behalf of any of the participants (some of whom will be making their own submissions), but we have sought to reflect key points made during the discussion and, where appropriate, to draw on that discussion and the group's professional experience in our submission.

Two key, guiding principles received strong support from the think tank group, and are endorsed by PILCH:

- a) **all** NFP organisations should continue to be required to maintain proper financial records and accounts; and
- b) **all** NFP organisations should be required to report to an external regulator because of the public nature of their purpose.

It was agreed by the group (and endorsed by PILCH) that it would not be good public policy to exempt any NFPs from a minimum level of financial accountability, especially given that the Australian Tax Office does not provide effective regulation of NFP organisations - it was noted that if an NFP is income exempt (as the majority are), it is not required to lodge a taxation return. Without any statutory obligation to lodge annual financial reports, NFPs (particularly those that do not receive external funding eg, from government) could easily slip into the practice of not preparing proper financial statements. This, in turn, has important implications for the good governance and risk management of those organisations, and for the reputation of (and confidence in) the NFP sector as a whole.

In summary, a minimum standard of disclosure that is simplified and tailored to the NFP situation should be required of all NFPs because:

- it promotes good internal governance and risk management practices;

- there is a strong public interest in the activities of NFP organisations and public disclosure provides a basis for information gathering by current and prospective stakeholders (eg, members, clients, donors, other funders and policy makers); and
- 'hands on' experience of the think tank group is that internal mechanisms of ensuring good governance (eg, relying on members) are, of themselves, often inadequate.

Above this minimum standard of public financial accountability, differential reporting obligations based on size were considered desirable. This point is discussed further under the specific questions raised in the Treasury Paper.

There was considerable discussion about the application of current and proposed accounting standards to NFPs. Also, the cost and difficulties associated with full audits. It was suggested that the basic reporting required of all NFPs should not require compliance with the full set of accounting standards, or even the new standards for SME's.

Given that the nature of NFPs, and the information needs of their stakeholders, are different to 'for profits', PILCH is of the view that a NFP-specific accounting framework needs to be devised. The worked undertaken on a standard chart of accounts by the Centre for Philanthropy and NonProfit Studies at Queensland University of Technology should inform such a framework.

It was acknowledged that even if the requirements under the Corporations Act are improved (ie, simplified more appropriate information is filed by small NFPs and full accounts are lodged by larger NFPs), this reform will be effectively negated if government (or other) funding agreements are not changed to mirror this approach (ie, they place a more onerous financial reporting obligation on small NFPs). PILCH urges Treasury to pursue this issue across other government departments.

#### **4. Specific questions in Treasury Discussion Paper**

Our responses to each of the questions raised in the Discussion Paper are brief as they are largely evident from the guiding principles outlined previously.

- 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?*

In principle, a differential reporting regime based on size is supported by PILCH. As discussed above, a minimum public disclosure standard should apply for all NFPs regardless of size, but full audited accounts should only be required from larger NFPs. The think tank group (and PILCH) agreed that, as a guide, the audit function should not cost more than 1% of the annual income of the organisation. A two-tier reporting regime should be introduced such that NFPs under, for example, a \$500,000 income threshold, would be required to report, but in accordance with a standard that is simplified and tailored to the NFP situation: ie, less onerous than the current full accounting standards or proposed SME regime.

The \$500,000 threshold mentioned above was chosen as a benchmark based on a full audit cost of approximately \$5,000 for a small NFP organisation. However, more work needs to be done to test whether or not this is the most appropriate threshold in the light of the size of those CLGs currently on the ASIC register.

- 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?*

There was not a great deal of discussion of this point by the think tank group, but generally the view was that size alone may be the easiest and clearest method of differentiation.

However, the determinates of size need to take account of the NFP context – namely, it is not appropriate to use the same criteria as applied to 'for profits'.

- 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?*

See above – all NFPs should have some reporting obligation. If some NFP entities are exempt from any public reporting obligation, grantors will (in relation to those exempt NFPs that obtain external funding) become the de-facto regulators. This is inappropriate because grantors have a different focus to a broad public policy of good governance by NFPs and, particularly in the case of philanthropic or corporate funding, the public has no assurance (or way of knowing) that the grantor will follow up with the NFP and/or take action if moneys are not properly expended. Other than not funding that NFP again, grantors do not have any practical enforcement powers and may not want it to be known that the funding they granted was wasted or not properly accounted for.

- 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?*

The suggestion of 5% of members being able to require an audit was discussed by the think tank group. Some practitioners had experience of such powers being used for disruptive purposes and felt that a number of other mechanisms are available to members to enable them to get the information they require, short of requiring an audit. In the case of small NFPs, the unexpected cost of such an audit (especially where the accounts did not currently need to comply with the full accounting standards) may jeopardise the organisation's very existence.

It was agreed that a residual power that allows a member to seek an independent review by ASIC was a more attractive option. However, practical experience was that it was often extremely difficult to get ASIC interested in using its powers in a NFP context. ASIC should be taking a more proactive role in regulating NFP companies. PILCH agrees that, in relation to NFPs, ASIC needs to be more proactive in the use of its existing investigative powers. Ideally, a new independent NFP-specific regulator should be established.

- 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)?*

Yes, a simplified minimum form of disclosure should be developed as a baseline, with additional requirements for larger NFPs. In our view, this baseline disclosure should identify sources of income (membership fees, grant income, fee income etc) and any related party transactions. In relation to this latter point, PILCH is of the view that the existing exemption for CLGs that hold a licence to omit the word 'limited' from their name should be removed.

The think tank group did briefly discuss the introduction of descriptive information (ie, in addition to financial information). While it can be difficult to ensure that such a requirement is neither onerous or meaningless (ie, not just a repetition of the organisation's objects clause), PILCH supports the requirement of a short statement of what activities the organisation has undertaken and how it has worked to achieve its mission during the last reporting period. This information is important for NFP stakeholders and considered best practice within the sector.

- 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?*

A simplified baseline form of financial report should be prescribed in an appropriate accounting standard. The issue of standardisation between companies and incorporated associations would then need to be resolved. In order to reduce costs and red tape, it is critical that all jurisdictions apply the same standard, and that government grants rely on this information rather than imposing unnecessary additional or different requirements.

- 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.*

A full review of the audited accounts of those CLGs currently on ASIC's register would be the best way to obtain this information.

- 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)?*

See earlier discussion. No NFP should be exempt from a requirement of baseline public disclosure. Best practice guidelines could be of assistance *in addition* to this requirement, especially if supported by freely disseminated information and low-cost, accessible training.

- 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?*

See discussion above. There needs to be a tailored two-tiered accounting standard for NFPs. The cost of auditing and a shortage of expertise within the accounting profession about NFP financial reporting issues are major problems for the sector.

- 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?*

Companies limited by guarantee are generally assumed to be NFPs and as such they should not be permitted to distribute dividends to members. The Corporations Act should be amended accordingly.

If you would like any further information or would like to discuss our submission, please do not hesitate to contact Ms Sue Woodward (PILCH Policy Officer).

Yours sincerely,



Ms Kristen Hilton  
Executive Director