

Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

30 July 2008

Dear Sir/Madam

Re: Submission to the Inquiry into disclosure regimes for charities and not-for-profit organisations.

I write to draw to your attention to existing research relevant to your Inquiry and to draw from that research recommendations to the Committee about regulatory reform for disclosure regimes for charities and not-for-profit organisations. The attached submission responds to each of the terms of reference.

The key recommendations in this submission are

1. **One size does not fit all** – that any proposals for the reform of the disclosure regimes must take account of the wide differences in the size and “publicness” of charities and not-for-profit organisations;
2. **No forced migration of existing not-for-profit to new forms of incorporation** – that mandatory migration to new forms of incorporation will not address the quality of reporting without other measures and would be very expensive and disruptive;
3. **New, differential reporting regime for all not-for-profit organisations, including charities, linked to tax status** - that new mandatory, differential reporting standards be developed for four classes of organisations – small private not-for-profit organisations, large private not-for-profit organisations, small public not-for-profit organisations and large public not-for-profit organisations. That compliance with these national standards is linked to continued endorsement of tax status;
4. **Mandatory cost of fundraising and cost of administration disclosures will not achieve the regulators purposes** – that the Committee not recommend the disclosure of cost of fundraising and cost of administration ratios;
5. **Annual Reports – not just financial statements - and publication on the world wide web-** that the Committee recommend a new reporting

regime that is based on reporting both narrative reports and financial statements on the world wide web;

6. **Co-regulation with industry bodies** – that the Committee recommend a new reporting regime that “leverages” the considerable power of industry and professional codes of practice;
7. **Comprehensive accounting standards for not-for-profit organisations** – that the Committee recommend to government that funding be made available to the Australian Accounting Standards Board to develop an appropriate set of accounting standards that respond to the special needs of not-for-profit organisations;
8. **A standard chart of accounts for reporting of government funding** – that the Committee recommend to the government that it develop a Standard Chart of Accounts for use with all federal government funding agreements with not-for-profit organisations;
9. **A standard data dictionary for reporting government funded services** - that the Committee recommend to the government that it develop a standard data dictionary for use with all federal government service agree agreements and contracts with not-for-profit organisations;

I respectfully request an opportunity to speak to members of the Committee on these recommendations at some suitable opportunity.

Yours faithfully,

Dr Ted Flack, PhD. CFRE

Responses to the Terms of Reference

- (a) *Relevance and appropriateness of current disclosure regimes for charities and all other not-for-profit organisations*

One size does not fit all.

Whilst it is widely recognised that the current government regulatory framework for charities and other not-for-profit organisations in Australia is less than adequate, it would be a mistake to suggest, as others have done, that there is a simple 'one-size-fits-all' government regulation solution to the public policy challenges that arise from a careful consideration of the issues.

Whatever level of government is made responsible for the regulation of this diverse set of organisations, some consideration will need to be given to the differences in the scale and public nature of these organisations.

Size is an important consideration. It is argued that it is appropriate for a large public fundraising charity with professional staff and significant financial resources to be required to produce comprehensive publicly available information about its activities and its financial position. In this case, high standards of statistical information and full, general purpose financial statements might be expected to be publicly available.

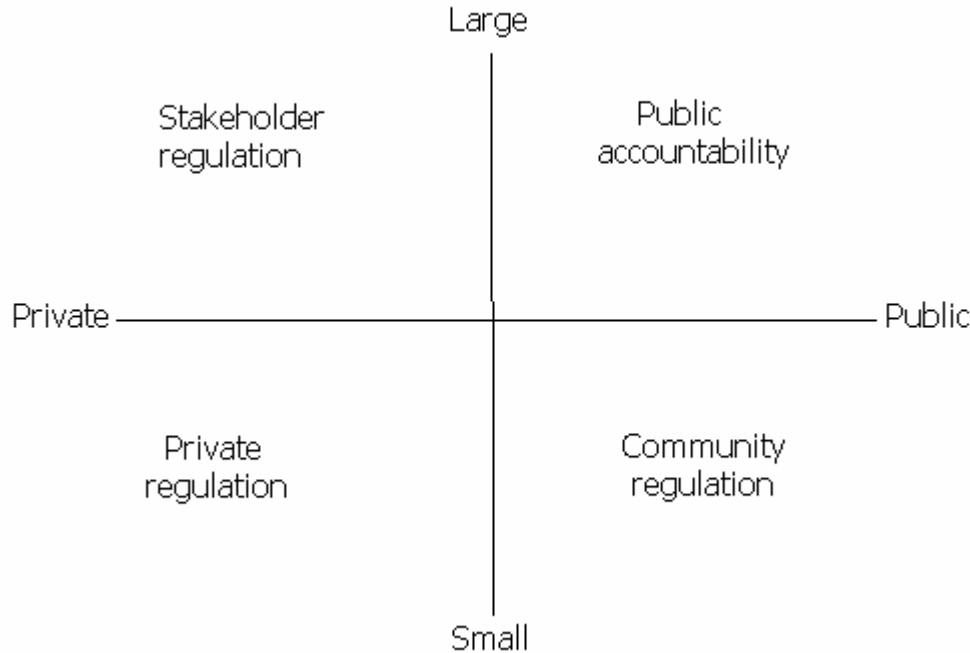
On the other hand, a small local, all volunteer not-for-profit organisation (might also have purposes that are charitable) that does not conduct appeals to the public and which has no professional staff and few financial resources, might not be expected to comply with the disclosure regime suited to a much larger public fundraising charity.

The extent to which the organisation is a public organisation is also important. It is argued that it is appropriate for charities and other not-for-profit organisations that are publicly funded (either by way of extensive public fundraising or by a significant level of government funding) to be required to produce comprehensive publicly available information about their activities and the financial position. In this case, high standards of narrative and statistical information and full general purpose financial statements might be expected.

However, charities and other not-for-profit organisations that are essentially the private affair of the participants should not be required to make comprehensive public disclosures of their activities or finances. The regulation of these private associations (including charitable associations) could reasonably be left to the participants.

It follows from this analysis that conceptually there are four groups of not-for-profit organisations (including charities); there are small private not-for-profits,

large private not-for-profits, small public not-for-profits and large public not-for-profits as shown in the following diagram:



This submission argues that any proposal to migrate existing not-for-profit organisations to some new form of incorporation is unworkable because of the massive legal costs that would be incurred by not-for-profit organisations arising from such a proposal.

It is therefore recommended that the Committee should be considering ways in which to improve the standards of reporting rather than addressing the legal forms of these organisations.

The regulatory environment should therefore reflect the practical circumstances of these organisations as follows:

Class of organisation	Regulatory approach	Regulation
Small private not-for-profits	a simple legal form suitable for regulation by the participants	National model Associations Incorporation Act with minimum reporting requirements
Small public not-for-profits	Stakeholder regulation	Level 1 differential public reporting requirements under existing forms of incorporation with increased 'subscribing member' rights
Large private not-for-profits	Stakeholder regulation	Level 2 differential reporting under existing forms of incorporation
Large public not-for-profits	Public accountability	Public disclosure of level 2 differential reporting under existing forms of incorporation

What should be disclosed?

Level 1 differential reporting would be characterised by independently audited financial statements comprising modified cash accounting Income and Expenditure Statement and Balance Sheet. The financial statements should be accompanied by a simple directors' statement of activities conducted in pursuit of the mission of the organisation. The qualifications for the auditor could be relaxed to include suitably qualified but independent volunteers.

Level 2 differential reporting would be characterised by professionally audited general purpose financial reports as a component of a full annual report authorised by the directors providing a narrative explanation of the activities of the organisation.

Small public not-for-profit organisations could be permitted to choose either to move to Level 2 differential reporting or remain at Level 1 on the condition that they alter their constitutions or rules to allow non-member stakeholders, such as service users and donors, to participate in the Annual General Meeting of the organisation. The controllers of public not-for-profits that do not have a membership based form of incorporation would be required to report to a public meeting annually.

Mandatory cost of fundraising and cost of administration disclosures will not achieve the regulators purposes.

Because this is a contentious subject, the full explanation of the arguments in support of the proposition will not be included in this submission, however I tender as evidence CPNS Queensland University of Technology, Working Paper No. 26 which provides a full analysis of the issue. The paper can be downloaded from <http://eprints.qut.edu.au/archive/00004555/>.

Central to the arguments in this working paper is the proposition that cost of fundraising (or cost of administration) ratios are NOT any kind of measure of organisational or fundraising efficiency. Any meaningful analysis of fundraising efficiency is calculated in terms of the marginal cost of raising the next dollar, not the average cost of all dollars raised (which is what cost of fundraising ratios measure). Comparing charities on the basis of the average cost of funds raised, leads to misleading conclusions based not on efficiency but on underlying issues of popularity, size, length since established, etc. A narrative explanation of the activities of the organisation and the opportunity to question the controllers of the organisation are much more reliable mechanisms for judging performance.

If the intention of the regulators is to try to induce public fundraising charities to “compete” in a market for low cost of fundraising ratios, the regulators need to be aware that the unintended outcomes of such a competition are a range of unwanted behaviours including

- ◆ encouraging suppliers to make in-kind contributions to reduce fundraising costs; (eg. “We have a donor who pays for all of our printing costs”)
- ◆ encouraging charity managers to engage in sophisticated accounting techniques such as allocating a proportion of fundraising costs to artificial cost centres like “public education” or “brand awareness”.

Similarly, regulations that discourage allocating costs to “administration” is likely to reduce socially desirable expenditure on activities like staff training, risk management, compliance and workplace health and safety, or simply encourage reallocation to other operational cost centres.

Annual Reports – not just financial statements - and publication on the world wide web.

Whilst the focus of many commentators is on the financial affairs of not-for-profit organisations and charities, there is extensive research evidence that donors and volunteers in Australia do not rate the information contained in the financial statements as very useful. A wide range of stakeholders rate narrative information about the activities of the organisation and who runs them as more useful than the financial statements, although they think having access to the financial statements is very important as a “badge of honour” (See “The Role of

Annual Reports in a system of accountability for public fundraising charities” by Dr Ted Flack¹).

The mandatory publication of the annual reports of large public not-for-profit organisations on the world wide web is an inexpensive means of making information about not-for-profit organisations publicly accessible and reduces the cost of compliance with the requirement to lodge returns with various government regulators. The Committees attention is drawn to the recommendations of the recent State Services Authority of Victoria report entitled “Review of Not-for-Profit Regulation”² which stated

Removing the requirement for NFPs to submit an Annual Statement to CAV but mandating the public disclosure of financial reports on associations’ websites would be a more cost effective and efficient mechanism to achieve transparency and disclosure. p29

Co-regulation with industry bodies

The Committee may wish to consider the benefits of providing for the regulatory effect of the industry and professional bodies that operate in the not-for-profit sector. For example the **Australian Council for International Development** (ACFID) Code of Conduct contains a range of disclosure provisions which including the production of annual reports with full financial statements prepared in accordance with industry based standards.

Such industry-based systems of regulation requiring voluntary disclosure could provide powerful co-regulation within a less prescriptive government regulatory framework. Industry specific bodies like ACFID and Australian Council on Disability (ACROD), and other in the child care sub-sector, medical research sub-sector, etc, should be encouraged to develop reporting criteria that reflect contemporary best practice in those sub-sectors. The professional and industry networks can bring significant peer pressure to comply on others in their industry.

¹ <http://adt.library.qut.edu.au/adt-qut/public/adt-QUT20070726.123513/>

² [http://www.ssa.vic.gov.au/CA2571410025903D/WebObj/NFP_FinalRpt/\\$File/NFP_FinalRpt.pdf](http://www.ssa.vic.gov.au/CA2571410025903D/WebObj/NFP_FinalRpt/$File/NFP_FinalRpt.pdf)

(b) *models of regulation and legal forms that would improve governance and management of charities and not-for-profit organisations and cater for emerging social enterprise*

It is recommended that very careful consideration should be given to adding any new forms of incorporation to an already crowded field. Unless there is compelling evidence that a new form is necessary for “emerging social enterprises” because the existing legal forms are inadequate, no new forms should be considered. Rather amendments to the existing legal frameworks should be considered if necessary.

Practitioner experience in Australia, US and the UK and the available research on governance suggests that further regulation is not the answer to inducing improved governance and management of charities and not-for-profit organisations. Increases in either the actual or perceived burden of compliance for volunteer directors and committee members of not-for-profit organisations will add to the existing difficulty in recruiting people to fulfil these roles.

Alternatives to government regulation

The most promising avenues available for improving the governance and management of not-for-profit organisations are education and peer pressure. The research clearly indicates that most volunteer directors are keen to learn more about their roles and the expectations for their performance. Most directors of larger not-for-profit organisations are keenly aware of the need to maintain their reputation amongst those whose opinion matters to them. This is likely to be the most powerful moderator of their behaviour and this insight should be used as the “lever” in co-regulation with industry and professional bodies.

In my research into systems of accountability in public fundraising charities, it was found that there are multiple interlocking systems of accountability operational to some extent in these organisations. The following are extracts from the research findings:

The first system was the formal membership-based accountability system, based on the legally binding provisions in the organisations' constitutions and rules.³ Annual reports were found to have a central role in this system of accountability.

The second was the system of accountability based on the rewards and sanctions from the wider community, based on the reputation of the organisation.

There was evidence that annual reports (particularly those that are perceived as conforming with "best practice") also have a role in the reputation system of accountability, in that annual reports appear to have a role in helping to position the

³ The legal forms most commonly adopted by public fundraising charities in Australia are Incorporated Associations and Companies Limited by Guarantee. Both of these legal forms have constitutions and rules that provide for a membership, annual meetings of members to hear the report of the board and for the election of the board or committee of management.

Submission from Dr Ted Flack

charity as a competent and well managed organisation in the perceptions of some stakeholders.

The third was the government regulatory system that applies to public fundraising charities in Queensland.

The exaggerated perception that many stakeholders have that the regulatory authorities are actively engaged in monitoring the activities of public fundraising charities may also create the impression that the regulatory authorities provide stakeholders with an alternative system of accountability.

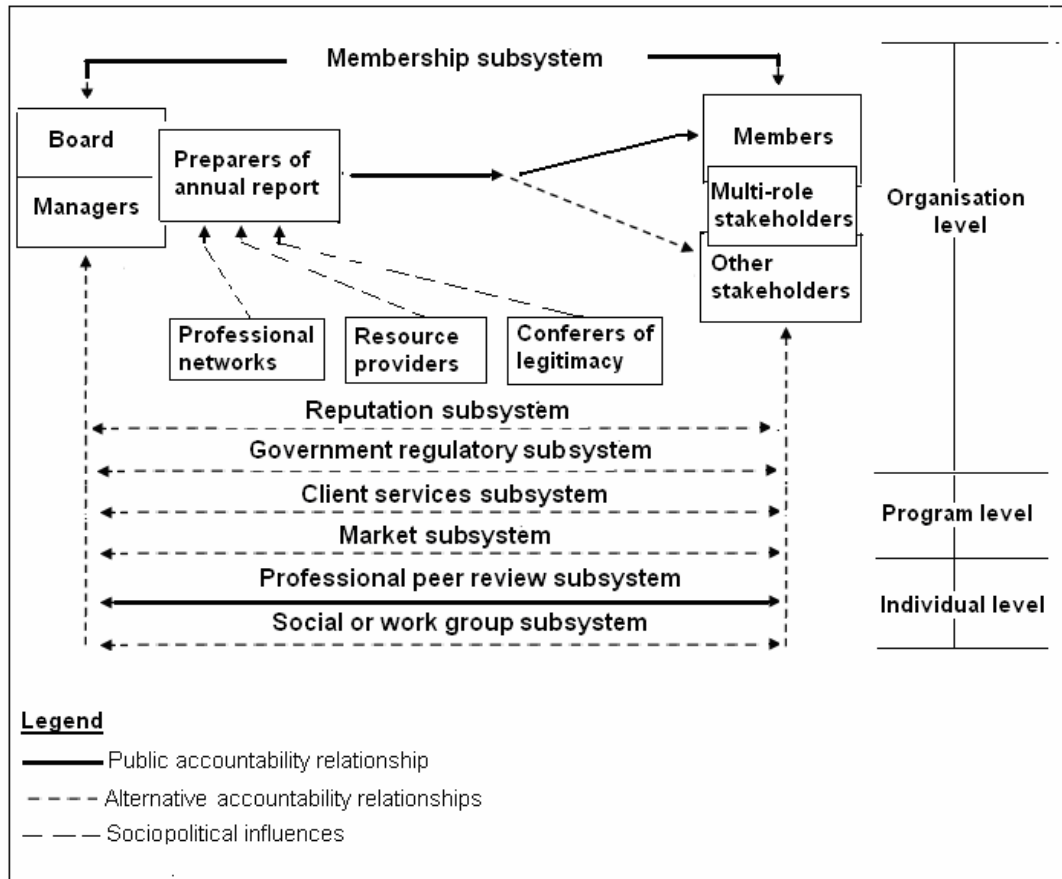
The fourth system of accountability was the client services accountability system, which focuses on the relationship between service providers of a particular program and the users of that service.

For the purposes of this analysis, accountability to government funding agencies for program funding and performance was classified as a part of this client services system of accountability.

Fifth, was a market-based system of accountability in which stakeholders are treated as customers by program managers. In this system, customers have the normal range of options available, in that they can choose to continue to "purchase" the goods and services provided by the charity, they can make a complaint, or they can chose to "exit". Program managers are likely to be held accountable for sustained adverse changes in customer relations by senior managers...

(Extract from: <http://adt.library.qut.edu.au/adt-qut/public/adt-QUT20070726.123513/>)

Conceptual model of the system of accountability at three organisational levels in membership-based public fundraising charities



What information should be disclosed?

It seems likely from the available research, that there is a core group of information requirements that non-specialist members of public might reasonably expect to be made available to them. The following table reflects recent research findings on the information preferences of Australian stakeholders :

Types of annual report disclosures nominated and valued by stakeholders in stratified sample of Australian public fundraising charities (in descending order)

Information preferences of stakeholders in the stratified sample (in descending order)	Representatives of Stakeholder Groups													
	Managers	Board	Members	Employees	Prof. HS Staff	Volunteers	Donors	Govt. funders	Regulators	Peak bodies	Media	Prof. bodies	Govt. funders	Total count
Total numbers of stakeholders	8	11	19	6	5	10	6	2	1	3	3	2	2	79
Financial statements	8	7	17	3		6	5	2	1	3	3	2	2	59
Board reports (including office bearers' reports)	8	7	19	6	1	7	5							53
Description of activities		8	9	3	1	7	4							32
Profile of board members	5	7	3			1	4							20
Progress against plans	2	6	6				5							19
Recognition of volunteers, donors and pioneers	5	7		1		3	1	1						18
Human interest stories	4	2	6	1		4	1							18
Financial health trends (or treasurer's commentary)		9					5	2						16

Notes:

1. Although a large majority of stakeholders said they wanted to be provided with financial statements, most also said they did not use them or did not understand them. The research found that the value of financial statement lies in their symbolic value in that they signal that proper financial oversight is in place.
2. Stakeholders who have a personal interest in these organisations tend to want to be provided with “soft” information about the organisation. Preferred disclosures include board reports, descriptions of activities, profiles of board members and human interest stories about the organisation.

Any regulatory response needs to take in to account these information preferences.

- (c) *other measures that can be taken by government and the not-for-profit sector to assist the sector to improve governance, standards, accountability and transparency in use of public and government funds.*

There are several pressing issues that government can do something about to improve accountability and transparency. They are:

1. Comprehensive accounting standards for not-for-profit organisations
2. A standard chart of accounts for reporting of government funding
3. A standard data dictionary for reporting government funded services

Rather than detailing the issues and the proposed solutions, I would like to draw the Committees attention to the following reports and projects:

Accounting standards for not-for-profit organisations

The disclosure of comparable financial information is the foundation stone of not-for-profit accountability and transparency. Whilst ever there is wide discretion available to accountants to report important not-for-profit financial transactions in their choice of ways, this foundation stone is an illusion.

See for example:

The Industry Commission In their report entitled "Charitable Organisations in Australia", Report No. 45, 16 June 1995, the Industry Commission stated:

"Public accountability requirements of Community Social Welfare Organisations (CSWO's) across Australia are currently varied and ill-defined. This is partly due to the diverse legal structure of CSWO's; the lack of specific accounting standards for the sector; and the not-for-profit status of CSWO's, which absolves them from the requirement to lodge tax returns."

The Industry Commission made the following recommendation, which addresses the problem of the lack of specific accounting standards:

"The Commonwealth government should provide funds to the Australian Accounting Standards Board and the Public Sector Accounting Standards Board to develop within two years suitable accounting standards for Community Social Welfare Organisations."

The Commission believed that better financial accountability would be promoted by the development of a specific accounting standard for the sector. This standard would be in addition to the current Australian Accounting Standards and would contain reporting requirements specific to the sector.

Professor Booth (1997:114) stated it clearly when he wrote:

"No accounting standard will ever solve all nonprofit entities accounting problems, even if they are solvable. At best, they can act

to standardise practice and to increase the level of disclosure useful to interests external to the nonprofit organisation. It is therefore critical that NPOs, both individually and as a sector, identify accounting practices that they believe meet the above ends and best serve the accountability relationships that they confront. They must then be prepared to lobby standard setters to achieve the embedding of these practices in regulation”.

The case for sector specific accounting standards could not be stronger. The doctrinaire, one-standard-for-all-approach is more of a reflection of the accounting standard setters’ allocation of scarce resources than it is about the need for such a standard.

The Committee is urged to make recommendation that the Commonwealth government fund the Australian Accounting Standards Board to develop sector specific accounting standards for the not-for-profit sector.

A standard chart of accounts for reporting of government funding.

Rather than detail the need for a standard chart of accounts for the reporting of government funds by funded not-for-profit organisations, I draw the Committee’s attention to the Centre of Philanthropy and Nonprofit Studies (CPNS) Chart of Accounts Project and the research that initiated the project.

A copy of the research report “Financial Reporting by Australian Nonprofit Organisations: Dilemmas Posed by Government Funders” by Drs Ted Flack and Christine Ryan is attached to this submission.

The research found that

The findings confirmed the anecdotal evidence of multiple and irreconcilable differences in the reporting requirements of government funding programs reported by nonprofit accounting practitioners. They also provided confirmation of the difficulties posed by the different definitions and instructions that are incompatible with regulatory requirements for the accounting treatment of some transactions. The data collected generally supports practitioners’ contention that the multiple and incompatible reporting requirements of funding departments impose significant compliance costs on government funded nonprofit organisations.

In response to these finding, CPNS in conjunction with Queensland Treasury developed a standard chart of accounts for use by all government departments requiring financial reports from not-for-profit organisations. Details of the project are available at

<https://wiki.qut.edu.au/display/CPNS/Standard+Chart+of+Accounts>

The Committee is urged to recommend to the Australian Government a similar standardised chart of accounts.

A standard data dictionary for reporting government funded services

Rather than detail the need for a standard data dictionary for the reporting of government funds services by funded not-for-profit organisations, I draw the Committee's attention to the State Services Authority of Victoria's report entitled "Review of Not-for-Profit Regulation"⁴ which stated

Data collection is perceived as one of the most onerous requirements of service agreements. All the case study organisations interviewed by the Review raised the burden imposed by data collection requirements. Many NFPs reported that service agreements impose requirements for reporting data using a large number of different and often incompatible electronic data collection platforms. In addition, the Review found that data requests are frequently excessive and inconsistent.

The Authority recommended:

To reduce the burden caused by multiple data collection and reporting systems, all Departments with service agreements should:

- ◆ establish minimum data requirements for effective performance monitoring of services;
- ◆ review the existing data that service providers are required to collect against the minimum data requirements and rationalise reporting accordingly; and
- ◆ establish regular reporting of data back to each reporting organisation.

It is recommended that the Committee recommend to the Commonwealth government that it undertakes a review of the data collected under funding agreements with not-for-profit organisations in order to implement a standard data dictionary as soon as possible.

⁴ [http://www.ssa.vic.gov.au/CA2571410025903D/WebObj/NFP_FinalRpt/\\$File/NFP_FinalRpt.pdf](http://www.ssa.vic.gov.au/CA2571410025903D/WebObj/NFP_FinalRpt/$File/NFP_FinalRpt.pdf)