

**Financial Reporting by Australian Nonprofit Organisations:
Dilemmas Posed by Government Funders**

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ABSTRACT

Nonprofit organisations comprise a growing and important sector of the Australian economy. Moreover, this sector is being used by governments to an increasing extent for the delivery of services. The most common manner in which nonprofit organisations are funded by government departments is through the provision of grants, contracts or service agreements. This paper examines the financial accountability requirements of government funders, in one jurisdiction in Australia. The research found evidence of incompatible financial reporting requirements across departments, dilemmas in the treatment of revenue, a clear preference by departments for a 'fund accounting' framework, and a ubiquitous requirement for the valuation of contributions in kind. The findings of this research support the central argument in the paper that the emphasis on upward and external accountabilities serve as a functional and control tool on the sector, and this detracts from the development of the downward and internal mechanisms of accountability which are the essential building blocks for the development of the capacity of the sector to respond to calls for greater accountability. The paper will be of interest to government funders, nonprofit practitioners and accounting standard setters, auditor practitioners and regulators.

1.0 Introduction

Governments at Federal, State and local levels in Australia are important sources of the financial resources of nonprofit organisations. Australian governments contributed \$10.1 billion or 31.3% of the total revenue of nonprofit organisations in 2000-01, compared to the \$2.9 billion contributed by household donations and membership dues, and \$.4 billion provided by corporate donations (ABS 2002). These financial resources are provided by governments to nonprofit organisations, on the one hand, to fund services and facilities that further the objectives of governments and, on the other, to further the missions of the funded nonprofit organisations (Auditor General of Western Australia, 2000; Brown and Ryan, 2003). In an age where governments are increasingly reliant on the nonprofit sector to deliver many core public services, it is vital that the sector develops the internal mechanisms, capabilities and capacities which allow it to measure its own performance and also to demonstrate that performance and accountability to the Australian community. Data that truly measures performance, allows comparability, and builds capacity in the sector is essential.

Ebrahim (2003) draws the distinction between the traditional (or external) form of accountability and the capacity building (internal) form of accountability, arguing that long term legitimacy and reputation of the nonprofit sector will more likely be built when the focus is on the internal forms of accountability. For this to occur there needs to be an understanding of the basis of accountability and an agreement on the tools of accountability. Ebrahim (2003) applies this distinction in his discussion about the relationship between nonprofits and their funders. Drawing on the situation in the US, where donors are major funders of the sector, he argues that accountabilities to donors have resulted in excessive conditions and onerous reporting requirements being attached to funding. The immediate implication from this is the significant compliance costs being imposed on the sector (Industry Commission 1995; McGregor-Lowndes 1993a, 1993b; Office of Economic and Statistical Research, 1999), and the broader implication is that the reporting regime required by the major funders has a substantial impact on the 'shape' of that organisation. Consequently, it could be argued that funders and regulators have a crucial role in assisting the sector in building the internal capacity and assessment tools necessary to conduct long term evaluations of the services provided.

In Australia, when receiving funds to deliver funded services, nonprofit organisations typically enter into a contract or service agreement with the funding government department which specifies both the measures of the services to be delivered and the system of financial accountability required. The aim of this paper is to examine the entire set of funding agreements between government and nonprofit organisations in one jurisdiction in Australia to

obtain detailed empirical evidence on the financial accountability information requirements of government funders. This study will provide the evidence to theoretically inform arguments on the impact that funders have on shaping the accountability of nonprofit organisations and provide evidence on any inconsistencies in reporting requirements. The research will be of interest to government regulators when assessing reporting requirements, and to Australian accounting standard setters as they consider harmonisation with international accounting standards.

The paper proceeds as follows; the next section examines the specific theme of the paper, that of accountability, the section following draws data from the funding requirements of government departments to amplify the accountability issues. Policy implications are then drawn from the study.

2.0 Accountability Perspectives and Mechanisms

Traditional approaches to accountability examine the issue from the perspective of who is accountable, to whom are they accountable and for what they are accountable. Broadbent and Laughlin (2003) advance the arguments by distinguishing between the *authority* granted to a person or an organisation, versus that applying when managers are made accountable for the *responsibilities* delegated to them. They argue that one of the key differences in making this distinction relates to control. The level of control maintained by one who delegates responsibility is greater than when authority is granted to someone. The nature of the relationship between the two parties thus has an important bearing on the accountability mechanisms appropriate in any situation.

Broadbent and Laughlin (2003) tease out these relationships further, by examining different approaches to accountability. In describing the economic approach, using a principal and agent framework, they argue that rather than one linear relationship, there is a continuum of accountability. What differentiates one end of the spectrum from the other is the nature and level of expectations between the principal and agent. At one end of the spectrum, a principal may transfer funds to an agent, and the discharge of accountability is left entirely for the agent to define and acquit. At the other end of the spectrum, the principal directly controls the actions of the agent who has no autonomy. While economic principal/agent theorists have concentrated on understanding the contracts which exist between the principal and agent, much of the accountability literature develops an understanding of accountability relationships by examining those aspects of accountability systems which attempt to ensure the behavioural compliance of the agent.

Although the notion of 'trust' is not explored in any detail by Broadbent and Laughlin (2003), they do state that sometimes the various mechanisms to ensure behavioural compliance are not needed when there is a high level of trust that the 'agent' will comply with what the 'principal' requires. This theme of trust and its relationship to accountability in the nonprofit sector is further elaborated on by Ebrahim (2003). He examines five mechanisms of accountability (reports and disclosure statements; performance assessments; participation; self regulation and social audits) along three dimensions, upward-downward accountability, internal-external accountability, and functional-strategic accountability. He argues that traditional mechanisms of accountability focus on upward, external and functional dimensions, and have a short-term focus. In the past, in response to the demands of the providers of funds, nonprofit organisations have focussed on 'upward' and 'external' accountability to donors, foundations and other providers of funds. Ebrahim (2003) argues that the second dimension of accountability, 'downward' and 'internal' mechanisms, remain relatively underdeveloped. These refer to accountability to clients and communities served by the nonprofit organisation. Ebrahim's third dimension refers to accountability by organisations to themselves—to their mission, to their supporters and to their staff. For many nonprofit organisations, this capacity to maintain informal and social relationships as a part of internal mission focused and 'client centred' systems of accountability is the attribute that makes nonprofit organisations more trustworthy, more closely in touch with community values and needs and therefore attractive to governments as the means of providing services in the community (Bogart, 1995. Hansmann, 1980. Murray and Tassie, 1994. Seal and Vincent-Jones, 1997). However, all these accountability mechanisms are crucial for the survival of nonprofit organisations as they need to manage their relations with a diverse set of stakeholders who not only provide financial resources but also confer legitimacy (Kearns, 1996). Ebrahim argues that for the long term survival of the sector, the focus needs to be shifted from the external dimensions of accountability to internally driven mechanisms which can enhance the legitimacy, reputation and capacity building of the nonprofit sector.

A key tenant in shifting focus and in responding to the increasing calls from a range of stakeholders to be more accountable. is the preparedness of the sector to demonstrate performance on the promises implicit in their mission focus. Ebrahim (2003) argues that in this shift, it is not enough for nonprofits to rely solely on the trust afforded to them. He argues that funders and regulators have a responsibility in this respect to assist the nonprofit sector to build internal capacity and develop long-term assessment tools rather than relying too much on regular financial accountability reports. Thus, what needs to be built into organisations is the capacity to conduct long-term evaluations of their own work. If such evaluations are to occur, a mix of financial and non-financial performance data is required.

In this research, we focus on the quality and comparability of the financial data that would be used in that mix. An examination of the financial accountability requirements of a set of government funders in one Australian jurisdiction provides a 'window of opportunity' to examine the specific requirements of this powerful group of stakeholders. The prime building block of comparable financial data is a consistent categorisation and commonly accepted terminology of key concepts underpinning the data. Without this crucial building block, compliance costs increase, comparability of data is impossible, and the sector is locked into discharging external/upwards accountability at the expense of internal/downwards accountability and self-assessment.

3.0 Method

3.1 Data Collection

The aim of the research was to interrogate the funding agreements of state government departments as a 'window' into the financial reporting requirements placed by these funding departments on nonprofit organisations. All 24 Queensland state government departments that administer contracts or service agreements with nonprofit organisations were contacted and asked to provide copies of their financial accountability requirements under all programs. Since some Departments administer several different programs that involve funding agreements with nonprofit organisations, the letter asked Departments to provide details for each of the programs they administer. The letter was endorsed by the Queensland Treasury Department on behalf of the research project.

One of the problems with the collection of data was that the detailed financial reporting instructions and associated forms were not contained in a single document. Because the details sought were in some cases contained in several documents, four types of source documents were obtained from the funding departments: application for funding forms, periodic financial report formats, related explanatory documents, and those sections of funding agreements issued to funded nonprofit organisations that related to financial reporting.

3.2 Data Analysis

Of the 24 Queensland government departments, two departments did not have any special financial reporting requirements of the funded nonprofit organisations. One department required funded organisations to submit a 'profit and loss report for each quarter', together with the organisation's 'audited annual financial reports', whilst the other required a 'general ledger listing' for all financial transactions for each quarter. The requirements of these two departments

were not considered in our detailed analysis because they did not impose special reporting requirements on the nonprofit sector. In terms of our analysis, it is argued that they have moved beyond external accountability to relying on some trust in the accounts produced the nonprofit organisations.

The remaining 22 departments were involved in funding nonprofit organisations through 31 separate funding programs. For each funded program, a special purpose financial report was required to be submitted. The timing of the reporting varied between monthly, quarterly and annual requirements. The agencies included in the survey are listed in Appendix 1.

The original documents returned by each department varied considerably in content and format. In order to obtain some overall picture of the requirements, each document was coded for the department and program to which it belonged and each page was numbered to create a comprehensive index to all documents. A Microsoft Excel spreadsheet was then created with a column for each department. Each page of the indexed documents was examined for line descriptions of revenue, expenses, assets and liabilities and as each new item was located, its exact wording was added on a new row and the document reference was recorded in the column corresponding with the department that issued the document. Wherever instructions or explanations that contained any elaboration on financial requirements were contained in the documents, these were noted in Excel 'comments' in the relevant cells. Items that were clearly alternative wordings for similar items were grouped together until all lines of account appearing in all documents were recorded in a 'master chart of accounts'.

4.0 Findings and Policy implications

Our detailed analysis revealed that there were four major areas which presented problems: a range of incompatible financial reporting requirements across departments; dilemmas in the treatment of revenue; a clear preference by departments for a 'fund accounting' framework; and a ubiquitous requirement for the valuation of contributions in kind. Each of these findings will be discussed in turn.

4.1 Incompatible Line Descriptions and Aggregations

The first major finding is that there is a wide range of incompatible financial reporting requirements across departments and, in some cases, between different programs within the same department. A total of 129 different revenue line item descriptions and 836 different expense line item descriptions were identified in the departments' forms or instruction documents. Differences occurred both in the line descriptions and the accounting treatment for the same types of expenses. The major variation occurred around the material expense item for

labour costs. Our examination revealed a total of 113 different line descriptions in the documents that related to direct labour costs. For example, in the expenses category, departments included different items: for some, 'salaries' covered salaries only; for others, it included salaries and direct on-costs; whilst for others, 'wages and salaries' included items that were treated as 'costs of employment', such as 'staff training' and 'protective clothing'. In some cases, labour costs included staff transport; and some departments required workers compensation insurance to be treated as a salary and wages on-cost, while other departments aggregated this with general insurance.

The cost of compliance implications for funded nonprofit organisations of this variation in terminology and treatment are quite profound. Since a nonprofit organisation's accounting system is designed to capture financial transactions just once, an imposed requirement to report similar transactions in incompatible ways, means that nonprofit organisations that receive funding under agreements that have incompatible acquittal arrangements may have to manually recalculate financial transactions from the vouchers, adding significantly to the costs of compliance for the nonprofit.

The variation in terminology lends empirical weight to the claim by Ebrahim (2003) that external, fiduciary accountability is the focus of the reporting requirements of this group of government funding departments. The other implication that can be drawn from the use of such a wide variety of categorisation and terminology, is that such data could not usefully be aggregated. Since evaluations of performance rely to some extent on comparisons between the activities being evaluated (Suchman, 1969; Industry Commission, 1995; Steering Committee for the Review of Government Service Provision, 2004) it would appear that with such variations, government departments are unable to use this financial information to develop comparable data on financial performance or to build efficiency benchmarks of similar activities by different nonprofit organisations. The data appears only to be useful in determining whether the funds have been spent in accordance with the terms of a specific funding agreement, that is, for fiduciary stewardship. With government departments being a substantial provider of funds to the nonprofit sector and their increasing reliance on the sector to deliver services, a move to collecting comparable data would greatly facilitate the provision of feedback to the sector to increase their capacity to evaluate performance and hence their ability to respond to the call for them to be more accountable.

4.2 Inconsistency in the Treatment of Revenue Received in Advance

The second major finding from the interrogation of the data concerned the dilemma surrounding the treatment of revenue. This is particularly evident in relation to the treatment of unspent funds at the end of the financial year. Some departments required that unspent government funds were to be treated as liabilities, whilst others instructed that unspent funds were to be treated as surplus (asset) but that such surpluses would be carried forward to the new reporting period and may be used to offset funded program expenses in the new reporting period. The Urgent Issues Group (UIG) in Australia has considered the treatment of accounting for the contributions of non-current assets in its Abstract 11 issued in December 1996 (AASB, 2000). The UIG position is that revenue is recognised when control is obtained over it, and that in the case of any restrictions on revenue, these only be recognised as a liability when there is a present obligation to repay a contribution (par 9). It follows from the UIG Abstract, that in the majority of cases for external reporting for nonprofit agencies in Australia no details need to be given on restrictions placed on funds as there will be no immediate liability.

This issue has been identified as problematic in several other OECD countries. In the US, the Financial Accounting Standards Board has issued 'Statement of Financial Accounting Standards No. 116: Accounting for Contributions Received and Contributions Made' (FASB, 1993a) and 'Statement of Financial Accounting Standards No. 117: Financial Statements of Not-for-profit Organizations' (FASB, 1993b). These standards provide clear guidance on how non-governmental nonprofits should account for contributions that have attached conditions (Davies, 2003). It needs to be noted that the intent of SFAS 116 and 117 was to enhance the relevance, understandability and comparability of nonprofits' financial statements. SFAS 117 requires disclosure of contributions with donor-imposed restrictions, into net asset classes separating unrestricted, temporarily restricted, and permanently restricted.

In the UK, the accounting standards for charitable organisations known as Statement of Recommended Practices (SORP) specifies that the assets with restricted purposes imposed by donors and not available for the general purposes of the charity are to be separately disclosed as restricted assets (Charity Commission of England and Wales, 2000)

In a similar vein, Research Bulletin R-120 issued by the Institute of Chartered Accountants of New Zealand (ICANZ1999) entitled 'Financial Reporting by Voluntary Sector Entities' argues that the information on restrictions as to the use of revenues and assets should be provided in the financial statements. The New Zealand situation differs from that in Australia, to the extent that grants or donations subject to genuine conditions should not be recognised as revenue until those conditions are fulfilled. Prior to recognition as revenue, any conditions (restrictions on the

use) on revenue mean that the revenue should be accounted for as a refundable advance, i.e. treated as a liability (paragraph 5.3.1).

It is clear that accounting standard setters in other jurisdictions have recognised the need for an accounting standard for the treatment of revenue received in advance for specific (restricted) purposes by nonprofit organisations. Meanwhile, from the Australian nonprofit practitioners' perspective, the inconsistent treatment across government agencies, the conflicts created between the government funders' requirements and the way these transactions should be recorded in the nonprofit accounts in accordance with accounting standards, and the imposed requirements for special purpose financial reporting to government funding agencies, that can not be fulfilled from the nonprofits' accounting system, all contribute to increased compliance costs for nonprofit organisations. The inconsistencies across government departments and across funding programs, again, cast doubt on the use to which this information is being put by government.

4.3 Preference for 'Fund Accounting'

The third major finding concerned the 'orientation' of accounts, in other words, whether the accounts are prepared on a 'whole of entity' basis or on a 'fund accounting' basis.¹ There is ample evidence that funding departments continue to use a fund accounting framework. Of the 22 departments included in the study, 18 specified that separate bank accounts must be established for the conduct of the funded activity, whilst a further two departments stated that separate bank accounts would be required unless computerised accounting techniques were available, which would allow the funded nonprofit organisation to keep a separate 'fund' for the funded activity.

In addition, all 22 departments required nonprofit organisations to apply any donations received in support of the funded project or activity to the fund set up to administer the government funding. While this clearly is required because the government department wishes to gain some understanding of the extent of their funding to the total funding for the project, this requirement poses problems for nonprofit organisations. In the first instance, accounting treatment would normally have all donations in one account rather than being apportioned to certain projects. In the second instance, the ubiquitous requirement for donations to be applied to funded projects

¹ A fund 'is an independent fiscal and accounting entity with a self-balancing set of accounts recording cash and/or other resources together with all related liabilities, obligations, reserves, and equities which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulation, restrictions, or limitations' (Davies, 2003). In other words, in fund accounting money is allocated into separate funds, and financial statements and reports are drawn up by fund, or by grouping funds together.

is likely to cause difficulties for those nonprofit organisations that are endorsed by the Australian Tax Office (Australian Taxation Office, 2000) as 'Deductible Gift Recipients' (DGRs). These organisations are required by the Income Tax Assessment Act 1997 to establish a separate 'gift fund' into which all tax deductible donations are to be placed (Australian Taxation Office, 2003); this rules out accounting for donations for different projects in different 'funds'.

Australian accounting standard setters have also moved away from an acceptance of a fund accounting orientation towards a 'whole of entity' basis for the preparation of financial reports (see Australian Accounting Research Foundation, 1988), but Queensland government funding programs and the Australian Tax Office continue to rely on separate 'funds' for restricted purpose assets in the accounts of nonprofit organisations. This places nonprofit organisations in a dilemma when dealing with these transactions and in cases involving tax deductible gifts; it places them in jeopardy of breaching either their funding agreements with government funding agencies or breaching tax law.

4.4 Accounting for Contributions in Kind

The fourth major finding concerns the issue of 'the valuation of contributions in kind' from suppliers of goods or services or from volunteers. Fourteen of the 22 departments required that the funded nonprofit organisation report the value of contributions in kind either from the suppliers of goods and services or from volunteers. Only one of the departmental documents provided guidance on how such contributions should be valued, instructing that such contributions should be calculated and reported on the basis of the cost of purchasing the same or similar goods and services in the market.

This requirement has some considerable impact for nonprofit organisations. The prevalence of this type of activity, the nature of volunteering and contributions in kind in the nonprofit sector, and the practical difficulties of dollar quantification, are unique to the sector. The prevalence of contributions in kind to the sector is not paralleled in either the for-profit sector or the public sector. Consequently, the development of generally applicable accounting standards for the valuation of contributions in kind, especially in respect of volunteer labour, has been consistently declined by accounting standard setters in most OECD countries. Since the government funding department can have no legal claim to these contributions, it is difficult to reconcile the demand for the information.

The implications that flow from this requirement to put a value on contributions in kind are that government-funded nonprofit organisations are faced with further compliance costs. Also, the lack of a common standard once again leads to non-comparable financial data. This again

suggests that the information is being collected by government funding departments for acquittal and control purposes rather than performance evaluation.

5.0 Conclusion

The nonprofit sector is increasingly being used to deliver a significant proportion of services that were traditionally seen to be the function of government. Financial accountability by nonprofit organisations for the funds provided to the sector by government is a critical issue. What is equally important, though, is the building of the sector's capacity to demonstrate accountability for its performance. Indeed, the development of this capacity by nonprofit organisations may influence the support of the Australian community—one of the characteristics of nonprofit organisations that make them attractive to governments for service delivery. Traditional accountability mechanisms employed in all sectors emphasise 'upward and external' accountability - which is extensively covered by the financial and performance reporting requirements of government funding departments (Ebrahim, 2003). However, 'downward and internal' mechanisms of accountability for performance of their own mission and programs to other stakeholders are also important to nonprofit organisations, yet remain relatively underdeveloped (Ebrahim, 2003). These mechanisms are crucial for an improved understanding of the performance of nonprofit organisations in providing a range of services, and in building their short and long-term capacity to demonstrate their accountability.

The findings of this study confirm the emphasis by government funders in service agreements on mechanisms for 'upward' and 'external' accountability more in line with notions of 'acquittal' or 'receipt giving'. Importantly, the results of these practices are the heavy compliance costs on nonprofit organisations, and incomparable (and therefore less useful) data for the government. If the sector is to respond to calls for greater accountability, government funders need to standardise their requirements, so that both governments and nonprofit organisations are able to move to the next stage of more thorough performance assessment, which is so crucial to legitimacy and accountability.

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.

The findings of this research will be of use to accounting standard setters in that the research provides the first clear evidence of the financial information needs of an important group of resource providers to the nonprofit sector. It draws attention to the responses of overseas accounting standard setters to similar nonprofit accounting dilemmas. It also will be of use to government funding departments and to nonprofit accounting practitioners because it identifies areas where there are opportunities to reconcile differences in terminology and to work towards a common approach across departments and programs. Such coordination would help to reduce compliance costs in the nonprofit sector and assist the process of collecting and disseminating comparable data, an important contributor to the larger objective of making performance data more available to inform the accountability debate.

Future research could be directed to an investigation of the use to which government funding departments put the financial information provided to them.

APPENDIX 1

List of Government Departments in Survey

- 1 Arts Queensland
- 2 Department of Corrective Services
- 3 Education Queensland
- 4 Emergency Services, Business Support Services
- 5 Department of Employment and Training
- 6 Environmental Protection Agency (Incorporating Queensland Parks & Wildlife Services)
- 7 Department of Families
- 8 Queensland Health
- 9 Department of Housing – Community Housing
- 10 Department of Industrial Relations
- 11 Department of Innovation and Information Economy, Sport and Recreation Queensland
- 12 Justice and Attorney-General (no grant program)
- 13 Department of Natural Resources and Mines
- 14 Queensland Police Service
- 15 Department of Primary Industries
- 16 Department of Premier and Cabinet
- 17 Sports and Recreation Queensland (See Department of Innovation and Information Economy, Sport and Recreation Queensland above also)
- 18 State Development
- 19 Department of Tourism, Racing and Fair Trading
- 20 Queensland Transport
- 21 Department of Main Roads
- 22 Disability Services Queensland
- 23 Department of Aboriginal and Torres Strait Islander Policy – Disability Grants
- 24 Department of Local Government and Planning

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