

## Submission by Ken Crofts

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Department of the Senate  
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### **Inquiry into the disclosure regimes for charities and not-for-profit organisations**

I have broken my submission up into the three sections as promulgated by the inquiry:

- a. the relevance and appropriateness of current disclosure regimes for charities and all other not-for-profit organisations;
- 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 enterprises; and
- 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 its use of public and government funds.

My headings are slightly different to the above due to the emphasis I am placing on certain points, particularly those in relation to financial reporting.

I have also attached my profile below, to give some indication of my expertise and ability to comment on the issues raised in the inquiry.

#### ***Profile***

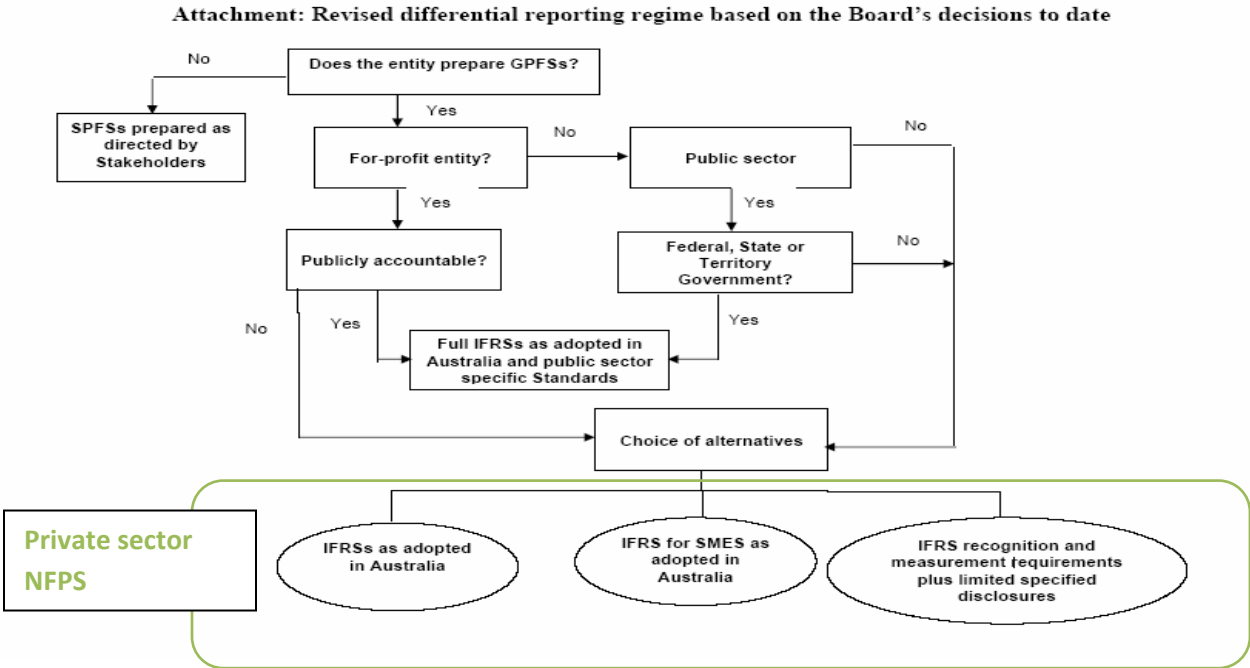
I have been a member of the Institute of Chartered Accountants in Australia since 1988 and have worked in a variety of accounting positions in both the public and private sectors. In particular relation to this submission I was employed as the ICT Officer involved with the NSW Community Technology Centres (CTC) program for several years, and was responsible for working with centres to help them formulate their grant applications and reporting requirements for the NSW CTC program. Since 2004, I have been employed as an accounting lecturer by Charles Sturt University and I have been undertaking a PhD on the Accountability reporting of NFP organisations to their stakeholders. This has involved a significant review of the literature in relation to not for profit reporting, as well as a number of interviews with financial and program managers of NFP organisations to gather their views on particular aspects of not for profit reporting, particularly in relation to accountability.

# A. Reporting and disclosure regimes for not for profit organisations including audit and assurance requirements.

## 1. Reporting framework.

Before looking in detail at the legislation that underpins the reporting requirements of not for profit organisations (NFPs), it is necessary to look at the current financial reporting regime in Australia that includes the use of International Financial Reporting Standards (IFRS). Australia has adopted IFRS which it is intended to apply to both for profit and not for profit entities. A number of accounting standards have been released which apply to entities in Australia. At the global level, the International Accounting Standards Board (IASB) in conjunction with the Financial Accounting Standards Board (FASB) in the USA have released an exposure draft entitled “An improved Conceptual Framework for Financial Reporting”. Whilst initially concentrating on private sector for profit businesses, the intention is for the Framework to be modified and *to apply to not for profit entities* at a later date. In anticipation of this the Australian Accounting Standards Board (AASB) has jointly issued a report <http://www.aasb.gov.au/admin/file/content102/c3/NSS-4%20Comment%20Document%20on%20Phase%20A%20ED%20and%20Phase%20D%20DP%20-%20FINAL.pdf> which highlights the issues and problems of applying the conceptual framework as it currently stands to not for profit entities.

With regard to differential reporting the AASB has tentatively adopted the strategy outlined in Agenda paper 16-2 <http://www.aasb.gov.au/admin/file/content102/c3/June%202008%20-%20Agenda%20paper%2016.2.pdf> to ensure that small companies are not subject to onerous reporting requirements. The following diagram from page 12 of the report summarises the approach.



With respect to private sector NFPs (as opposed to government organisations) they effectively fall into one of the three ellipses at the bottom of the diagram. Therefore there are three reporting categories:

- a) Full IFRSs as adopted in Australia (for large entities)
- b) IFRS for Small to Medium Enterprises (small to medium enterprises)
- c) IFRS recognition with limited disclosures (very small entities).

The intention is that large entities, with revenue and asset thresholds determined by the AASB, will have to comply with full IFRS reporting disclosures, regardless of whether they are for profit or not for profit entities. Similarly there is currently an exposure draft issued by the IASB on IFRS for SMES (now renamed as IFRS for private entities) which would normally apply to small and medium enterprises. The AASB expects that regulators may exempt certain small NFPs from reporting or devise minimum reporting requirements for such companies. Thus, even though the reporting requirements fall within a global framework, there is still flexibility at a national/state level for regulators to consider localised issues. “In the not for profit private sector, the AASB’s role would be limited to the provision of different choices of reporting requirements and the onus would be on other regulators or legislators and stakeholders to determine those entities in their jurisdictions that should apply one or other set of reporting requirements” (para. 46, p.10). On top of the base requirements, regulators could specify additional disclosure requirements, such as fundraising costs, if they wished.”

Whilst not currently high on the IASB’s agenda it is recommended that a separate not-for-profit accounting standard should be developed internationally, with customisation for Australia by the Australian Accounting Standards Board (AASB) to reflect local conditions.

It is strongly recommended that any future not for profit disclosure regime, sit within, and be consistent with the IASB conceptual framework (whether or not a specific not for profit accounting standard is developed), noting that the framework allows for sufficient flexibility for local variations and additional specific disclosures to be mandated. The worst possible outcome would be for disclosures to be mandated that are inconsistent with IFRS.

## ***2. Legislative regimes affecting NFP disclosure .***

One of the complexities of not for profit reporting in Australia is the variety of legal entities that are able to be used to structure a not for profit entity. These include:

- Unincorporated associations<sup>1</sup>
- Companies limited by guarantee
- Companies limited by shares<sup>2</sup>

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<sup>1</sup> Unincorporated associations are the most common form of legal structure by number

<sup>2</sup> The Australian Treasury recommended “... a differential reporting framework for unlisted public companies limited by shares that have a not for profit focus” (p.8)

- Incorporated associations<sup>3</sup>
- Co-operatives<sup>4</sup>
- Entities having legal status as a subsidiary of a government body
- Religious organisations that may or may not be statutory corporations
- Other statutory corporations
- Charitable trusts

It would be extremely costly and politically difficult to change the reporting requirements for every type of legal entity listed above. If an organisation is publicly accountable then theoretically it should report using IFRS regardless of its legal structure. However, it would be prudent to put into place a national disclosure regime of legislative reporting requirements that complement and provide more specific advice surrounding not for profit disclosures, as envisaged by the AASB.

This should no doubt include incorporated associations and companies limited by guarantee. Such legal entities are normally NFPs which take advantage of the special legal structures such entities provide. It is recommended that not for profit statutory corporations also be included, although it is acknowledged this will involve further complexity and require greater political intervention. For reporting purposes it does not significantly matter whether the reporting requirements are promulgated through a single national regulator or the same requirements are adopted by various regulators in a co-operative manner provided they are consistent and such uniformity can be agreed upon.

It is envisaged that differential reporting would take place according to the AASB's proposed framework outlined in Section 1 above. As small member serving NFPs are primarily accountable to their members there may be case for exempting them from lodging General Purpose Financial Statements (GPFS) and they may only need to report desired information to their members at an AGM. Other small NFPs may need to lodge a basic set of financial statements on a cash basis only.

In addition to differential reporting requirements primarily based on size, there should be additional specific disclosures in respect of charities.

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[http://www.associations.net.au/associations/6729/files/Financial\\_reporting\\_by\\_unlisted\\_public\\_companies\\_Treasury\\_Discussion\\_Paper.pdf](http://www.associations.net.au/associations/6729/files/Financial_reporting_by_unlisted_public_companies_Treasury_Discussion_Paper.pdf)

<sup>3</sup> Incorporated associations have differing reporting and audit requirements in every state

<sup>4</sup> Covered by co-operatives legislation at a state level

### ***3. Reporting by charities .***

There is currently legislation that covers disclosures by entities that undertake particular activities, most notably that charities have to comply with charity fundraising legislation which varies by state. It is recommended that most of the disclosure requirements under the current state based legislation be retained, but that it be amalgamated into a single national disclosure regime and reporting requirements be promulgated in the same way and by the same bodies as the general NFP disclosure requirements.

There have been calls for some parties such as Choice for disclosure of fundraising costs as a percentage of revenue as this will improve transparency and accountability in some respects. The limited research undertaken to date suggests that private donors do not take into account fundraising costs when making a decision to donate<sup>5</sup>, but are instead more concerned with the outcomes of NFP organisations.<sup>6</sup> Large funders and other stakeholders interested in this information can generally demand this from the NFP organisation without it having to be specifically legislated for in any case. The usefulness of such ratios in countries where it is already a requirement has also been called into question. “The fundraising ratio is perhaps the least useful of the ratios for several reasons. First there is ample evidence that non profits do not report fundraising expenses reliably - about 60% of public charities that file a Form 990 report no fundraising expenses at all. Second, unique circumstances facing a on profit might make its fundraising ration higher or lower than that of the other organisation.”<sup>7</sup>

Similarly, there is evidence the disclosure of overhead cost information costs more to provide than the benefits it generates.<sup>8</sup>

It is recommended that no mandatory disclosures of fundraising or overhead cost ratios be specified in legislation.

Further research into what information donors and other stakeholders require in terms of decisions to donate and accountability needs to be undertaken, as well as educating donors and other users about the usefulness and limitations of financial and non-financial information reported.

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<sup>5</sup> See for example Flack, T. 2006 <http://eprints.qut.edu.au/archive/00004555/>

<sup>6</sup> Parsons, L. 2002 “The impact of financial information and voluntary disclosures on contribution to not for profit organisations”.

<sup>7</sup> [www.guidestar.org](http://www.guidestar.org)

<sup>8</sup> See for example “nonprofit overhead cost study” Urban Institute's National Center for Charitable Statistics (NCCS) Center on Nonprofits and Philanthropy

#### ***4. Reporting for outcomes .***

There is generally agreement that information about the effectiveness of a NFP in carrying out its mission or objectives is of vital importance. In the Choice survey relating to charities<sup>9</sup> 97% of respondents agreed it was important they have information about the effectiveness of their favoured charity's work. In terms of best practice, NFPs should disclose information about their mission and objectives in reports to stakeholders and in their annual report.

Effectiveness relates to achievement of outcomes related to the mission of the organisation. The trouble is outcomes are difficult to measure. Quantitative outputs such as number of clients seen in a given time period are usually the KPIs measured by NFPs. Outcomes such as higher levels of self esteem by youth clients are difficult to measure and are affected by many factors, usually not just the programs run by a particular not for profit. New ways of reporting are being developed. Triple bottom line reporting emphasises the social and environmental outcomes as well as the financial ones. Other innovative reporting models such as the Social Return on Investment (SROI) model adopted by Red Sheriff<sup>10</sup> is another that can be adopted by NFPs.

It is recommended that NFPs specify their objectives and missions and demonstrate the effectiveness of achieving their mission through disclosure in the Annual Report and other reporting mechanisms. How this is done depends upon the unique circumstances of the NFP. Not only would it be impossible to cover the range of different effectiveness disclosures required through legislation, it would also stifle innovation in using new innovative reporting practices. It is recommended that further research be undertaken into new innovative ways of reporting social outcomes.

#### ***5. Audit and assurance .***

There are currently many difficulties in NFPs being able to retain auditors for certifying the annual financial reports. Not only are scarce resources being spent on the audit function, due to the skills shortage registered company auditors are simply not available particularly in regional areas. It is important that differential requirements for auditing are adopted, in tandem with the differential reporting requirements outlined in section 1. There should be a range of requirements from a full audit for large NFPs adopting full IFRS, down to no audit.

It is recommended that a further option currently available in New Zealand for NFPs be adopted in Australia. This is the concept of a review and not a full audit. This would be a negative assurance stating that nothing untowards was found, but would not be to the extent of a full audit requiring a true and fair view. This could be undertaken by accountants or other appropriate professionals who do not have full status as a registered company auditor. This would lessen the resource burden on NFPs and skilled

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<sup>9</sup> <http://www.choice.com.au/viewArticle.aspx?id=106240&catId=100268&tid=100008>

<sup>10</sup> [www.redf.org/download/sroi/SROIExcelModel.xls](http://www.redf.org/download/sroi/SROIExcelModel.xls)

people would be more readily available for this task. More detail explaining the differences between a review and a full audit are explained in the attached appendix: "Information for funding providers" produced by the New Zealand Institute of Chartered Accountants.

Currently the requirements for many government grants stipulate the annual accounts must be audited by a registered company auditor. It would be important that the requirements of such funding agreements be changed as well as the legislative requirements.

## ***6. Reporting for grants and other government income .***

It is important to recognise the reporting burden on NFPs arises not only from legislative requirements in terms of the disclosure regime for annual financial reports, but the burden is often exacerbated when reporting for grants or other government income.

Different government departments and sections across the three tiers of government use different terminology for income and expenditure, use different classifications for various types of expenditure, and different accounting methods, for example overhead allocation, have different reporting schedules and different qualitative reporting disclosures. Whilst attempts have been made to try and improve this situation<sup>11</sup> it is still very inconsistent.

It is recommended that nationally accepted definitions and classifications be used for NFP reporting such as the International Classification of Non-Profit Organisations (ICNPO) as adopted by the Australian Bureau of statistics<sup>12</sup>, and the John Hopkins Comparative Non Profit sector project. Classifications for financial statement items should comply with a standard such as the Standard Chart of Accounts developed by Queensland University of Technology<sup>13</sup>

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<sup>11</sup> See for example NSW government "Good practice grants administration"  
[http://www.dpc.nsw.gov.au/publications/memos\\_and\\_circulars/circulars/2006/c2006-35](http://www.dpc.nsw.gov.au/publications/memos_and_circulars/circulars/2006/c2006-35)

<sup>12</sup> ABS catalogue 8106.0 <http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/8106.0Explanatory%20Notes12006-07?OpenDocument#PARALINK11>

<sup>13</sup> <https://wiki.qut.edu.au/display/CPNS/Standard+Chart+of+Accounts>

## ***B. Models of regulation and legal forms and public benefits received by NFPs.***

### ***7. Public benefits .***

One of the reasons for structuring a legal entity as a not for profit, and indeed a prime reason for this Senate Inquiry is the assortment of public benefits that an NFP organisation can obtain. Public benefits include the ability to source funds from government and donors, and secondly concessional treatment relating to taxation and other matters<sup>14</sup> as compared to for profit organisations.

In the 2006/07 year Australian NFPS received \$25 billion from government sources and \$25 billion from donations, sponsorships and fundraising.<sup>15</sup> Many government grants are restricted to NFPs and the ability to fundraise from the public is often predicated on being an NFP.

Concessional treatment in respect of tax matters includes income tax exemption on earnings, fringe benefit tax concessions in terms of salary sacrifice for employees and the ability of donors to receive a tax deduction for donors. There are different requirements for a number of tax office concessions such as ITEC, deductible gift recipient (DGR), Public benevolent institution (PBI) to name just a few. Other agencies including Ausaid<sup>16</sup> have their own definitions of what criteria are required to obtain concessional treatment in respect of NFPs.

To avoid inconsistency and halt the confusion surrounding the concessions granted it is important that a standard definition of not for profit be developed for Australia and be consistently applied by all government agencies especially the Taxation Office. The recommendations contained in the Charities Definition Inquiry of 2001<sup>17</sup> in relation to definitions of charity and not for profit provide a useful starting point in this regard.

### ***8. A national regulator .***

Due to the inconsistencies and anomalies in terms of public benefits provided to NFPs and the inconsistent legislative reporting requirements imposed on NFPs using a different legal structure it is imperative that a national regulator be established that understands and can communicate with the NFP sector. For purposes of consistency this regulator should be responsible for the whole of the not for profit sector. Reporting disclosures and legislative requirements specific to charities, can be an additional requirement on top of the normal not for profit regulatory requirements. As stated previously

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<sup>14</sup> For example the ability to procure equipment and supplies at government pricing

<sup>15</sup> ABS Catalogue 8106.0

<sup>16</sup> [http://www.ausaid.gov.au/ngos/pdfs/oagds\\_guidelines.pdf](http://www.ausaid.gov.au/ngos/pdfs/oagds_guidelines.pdf)

<sup>17</sup> <http://www.cdi.gov.au/>



differential reporting form small NFPs can be accommodated within the IASB global reporting framework. In particular regulations for organisations that are currently incorporated associations or companies limited by guarantee should come under the auspices of the new regulatory body.

Whilst there is some rationale for the regulator to be a part of ASIC due its knowledge of regulations and reporting requirements, the major disadvantage is its focus on for profit organisations and its ambivalence to NFPs in the past. It is recommended that an independent regulator be established resourced in part by the savings from the abolition of regulation of state based incorporated associations and companies limited by guarantee together with an injection of commonwealth funds. If this regulator is able to provide consistency with both reporting and concessional treatments of NFPs there must be huge cost savings to both NFPs and government agencies that deal with them. The regulator should come under the auspices of government but have strong links with the NFP sector itself,<sup>18</sup> with government agencies that deal with NFPs, and organisations that can provide advise and expertise in relation to NFPs.<sup>19</sup>

The national regulator should not be finally responsible for making decisions regarding concessional treatments such as charitable status. This should lie with the responsible government agency such as the Tax Office of AusAID etc. However, the national regulator should be responsible for coming to decisions on classifications and categorisations including the definition of a not for profit organisation through consultation with a range of stakeholders. It would be expected that the Taxation Office and other agencies would utilise such classifications and definitions and would be required to explain why not if they chose otherwise.

The regulator would have a number of roles which it is contended are not conflicting.

- A consultative role in communication with the NFP sector.
- An advisory role in relation to NFPs themselves and also government agencies that deal with NFPs.<sup>20</sup>
- An educative role in terms of training and governance for NFPs, as well as users of NFP reports<sup>21</sup>
- An enforcement role in terms of regulatory and also reporting requirements.

It is vital that the role of the regulator include responsibility for legislating for reporting requirements. In New Zealand the role of the Charities Commission does not include responsibility for reporting

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<sup>18</sup> For example through the non profit roundtable and the

<sup>19</sup> For example universities and ANZTSR Australia & New Zealand Third sector research organisation

<sup>20</sup> For example Taxation Office and agencies providing grants to NFPs

<sup>21</sup> See following section

requirements and there have been some delays and confusion as another separate body the Ministry for Economic Development (MED) attempts to come to grips with the reporting issues.

### ***C. Other measures to improve governance, standards and accountability.***

A number of large NFPs are very proactive in terms of governance and accountability and many are seen to have higher governance standards than their for profit counterparts. However, due to the lack of resources and the extensive use of volunteers in many smaller NFPs, they often have difficulty in accessing appropriate resources and training to understand what good governance represents and can have difficulty in recruiting people with appropriate skills to the board.

It is important that appropriate resources are made available to small NFPs in innovative ways, particularly to those in remote and regional areas. Training modules should be made available online and through videoconferencing. A list of web resources such as that available through CPA Australia and the Institute of Chartered Accountants (ICAA) should be able to be easily accessed. Funding should be made available for experts in governance and reporting, such as university academics based in regional areas particularly, to be able to train and provide expertise to groups of NFPs.

Innovative practices that provide additional resources at little cost such as shared services arrangements that have already been used in federal, state and local government context should be explained to, and opportunity given for NFPs to adopt. In remote areas skills such as IT people may need to be shared between the private NFP sector and the public sector in order to retain the skills in the local area.

In terms of accountability, changes to policy and regulations need to be based on appropriate evidence. There is little research that has been undertaken, particularly in Australia, as to the information needs of NFP stakeholders including users of NFP services. It is vital that such research is undertaken and funded to provide an appropriate base on which to make policy decisions.