The Institute of Public Accountants

Submission to ACNC on NSCOA

31 March 2017

IPA - Deakin SME Research Centre

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In 2013, the IPA partnered with Deakin University to form the IPA Deakin SME Research Partnership, a first in Australia. This partnership has grown and evolved into the IPA assisting Deakin University in establishing the IPA-Deakin SME Research Centre in 2016. The goal of the Centre is to bring together practitioner insights with cutting edge SME academic research, to provide informed comment for substantive policy development.

The IPA-Deakin SME Research Centre comprises:

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30 March 2017

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Dear Mel

Consultation on the National Standard Chart of Accounts

The Institute of Public Accountants (IPA) is delighted to provide commentary on the consultation of the National Standard Chart of Accounts (NSCOA).

The IPA is a professional accounting body with members that are recognised for their practical, hands-on skills and broad understanding of the total business environment. Representing a membership of more than 35,000 individuals in Australia and in more than 80 countries, our members and student members are working across a broad range of professional employment and practice, including; industry, commerce, government, academia and private practice. More than 75 per cent of our members work in or with small business and SMEs and are recognised as the trusted advisers to these sectors.

The IPA's detailed comments are contained below.

If you wish to discuss any of our comments or would like further information then please don't hesitate to contact Vicki Stylianou at vicki.stylianou@publicaccountants.org.au or on mob. 0419 942733.

Yours sincerely

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Institute of Public Accountants

1. Introduction

The IPA at the outset commends the Australian Charities and Not-for-Profits Commission (ACNC) for taking the initiative to consult on the NSCOA. Greater transparency, consistency and comparability of annual information statements (AISs) and annual financial reports do not only enhance the amount and quality of information available to various stakeholders, but it also ensures that charities are accountable for their activities to a range of stakeholder groups. Researchers working at the IPA-Deakin University SME Research Centre, who have investigated the Australian charities' sector extensively, have found that charities' stakeholders demand a range of financial and non-financial information (eg Johansson, 2017; ACNC, 2015a, 2013a). While the ACNC has made significant headway in encouraging charities to produce more consistent and comparable financial information via the AISs (and the NSCOA), this commentary fundamentally focuses on the lack of efficiency information that is currently being produced by the charities' sector and the lack of efficiency information that is made available to the public via the AISs (and the NSCOA). This commentary also argues that as the primary objective of charities is to maximise service output to beneficiaries (Johansson, 2017; AASB, 2015a), traditional financial measures of performance reported in for-profit sector financial reports and emulated in not-for-profit sector financial reports do not meet the information needs of stakeholders. The public, like other stakeholder groups such as contributors, government/regulators and beneficiaries, demand information beyond that which is contained within the financial statements in order to determine whether a charity has fulfilled its charitable purpose. Accordingly, as charities operate to maximise service output to beneficiaries, this commentary argues there is a lack of efficiency data made available by charities in the AISs and in their financial report lodgements. More detailed expenditure data provided by charities to the ACNC would go a long way to addressing the information gap that exists between what information the public demands and the current reporting requirements governing charities and the NFP sectors. The above arguments are supported by robust research conducted by Johansson (2017), who utilised longitudinal data to track charities' financial reporting behaviours over a seven year period (ie 2008 to 2014). This commentary is framed around Johansson's research and it provides a summary of some of the results and conclusions drawn from this research.

2. Background

Accountability enables organisations to take responsibility for their actions (Fry, 1995) and charities have a range of stakeholders to which they are accountable. Contributors, beneficiaries, government/regulators, members and the public (as a stakeholder group) are considered the main stakeholder groups in the NFP (including charity) setting (eg Johansson, et al. 2017; Hyndman and McMahon, 2010). Contributors are those who provide financial resources to charities and beneficiaries are the recipients of a charity's services. However, charities have other important stakeholder groups – the public and members. The public is a significant source of contributions (ABS, 2015), in some cases, they may also be a charity's beneficiaries by virtue of legislation recognising that charities are required to provide a public benefit (Charities Act 2013). As taxpayers, the public also has an interest in how governments allocate taxpayers' monies in the form of grants and via tax exemptions to legitimate charities. The public is therefore an important stakeholder group that has an interest in the development of reporting requirements that assist in determining whether charities have indeed fulfilled their charitable purpose.

Annual reports are considered to be the key means in which organisations can discharge their accountability to external users (Connolly and Hyndman, 2013a). In recent years, regulators globally have sought to improve accountability of charities by reforming the reporting requirements relating to the contents of charities' annual reports. Charities' reporting requirements vary across international jurisdictions with some countries supporting greater regulation of financial and non-financial information. In Australia, historically, the content of annual reports and AISs have been largely unregulated. Recent reform efforts to reporting requirements suggest that a market approach to voluntary reporting has not delivered an optimal outcome in delivering stakeholders the information that they demand. Meanwhile, in the US, charities are required to complete an IRS Form (Form 990) for the IRS for tax purposes (IRS, 2014a). As part of the requirement for Form 990, charities are required to report on their mission, activities and provide a breakdown of expenses related to programs, fundraising and administration activities related to their top three programs (IRS, 2014b). Since 2005, charities in the UK have been required to include in their annual reports information about their objectives, activities, achievements and performance in order to comply with the SORP (The Charity Commission and Office of the Scottish Charity Regulator, 2015a, 2015b; Connolly et al., 2013).

In Australia, charities may assume one of several legal forms, which has implications for their reporting requirements. Charities are most commonly incorporated or unincorporated associations (26,992 or 71.4 per cent of charities) and are usually smaller organisations (less than A$1 million in annual revenues) (Cortis et al., 2015). Associations are regulated at the state and territory level and are also required to lodge annual reports with the ACNC. Larger charities (revenues of A$1 million or greater) usually choose to be companies limited by guarantee because it enables them to operate across multiple states and territories under federal law (eg ACNC Act 2012; Corporations Act 2001) rather than be subject to variations in reporting requirements across states and territories. A company limited by guarantee is a type of public company where each member's liability is limited to their contribution in the event that it is wound up (section 517, Corporations Act 2001). Companies limited by guarantee are also not permitted to distribute dividends to individuals, groups or members (section 254SA, Corporations Act 2001). In Australia, there are 9,673 companies limited by guarantee (Carey et al., 2014b) of which 4,713 (or nearly 50 per cent) are charities (Cortis et al., 2015).

Charitable companies have been affected by two major regulatory reforms that have consequences for the information that they report to the public. In 2010, amendments to the Corporations Act 2001 introduced the streamlined directors' report for companies limited by guarantee, which required companies (including charities) to provide information that is specifically relevant to NFPs in their annual reports. The second reform was the establishment of the ACNC in 2012, which replaced ASIC as the key regulatory body for charitable companies and introduced its own reporting requirements concerning AISs and annual reports. The ACNC also made charities' annual reports publicly available at no cost (ACNC, 2012), a departure from previous regulators such as ASIC, which required the public to pay a substantial fee for annual reports. In 2015, the AASB released exposure draft ED270 (AASB, 2015a), which aims to mandate the reporting of financial and non-financial information by NFPs, of which charities are a subset. ED270 was issued in response to concerns that NFPs were not disclosing information that is important to their stakeholders (AASB, 2015a) and has the stated purpose of mandating the reporting of information that is considered important so that stakeholders, such as donors and taxpayers, can assess the performance of NFP entities (AASB, 2015a). If successful, it will significantly impact charitable companies (AASB, 2015a).

Australian for-profit and NFP entities may prepare either a special purpose financial report (SPFR) or a general purpose financial report (GPFR). The type of financial report prepared is determined by the reporting entity concept. A reporting entity is one that has existing or potential users that are likely to be dependent on GPFRs in order to make and evaluate decisions regarding the allocation of scarce resources (SAC 1, AASB, 1990). SAC 1 outlines three factors that for-profit and NFP organisations may consider when determining whether their organisation is a reporting entity; namely separation of management from economic interest, economic or political importance and financial characteristics (paras 20-22, SAC 1, AASB, 1990). Applying these factors, entities that have greater separation of ownership and management, are economically and politically influential and are financially significant and these entities are more likely to have dependent users relying on GPFRs to obtain information about the entity's financial performance and position.

A NFP organisation can justify their economic, political and financial significance by considering their size and reliance on external resource providers (ie contributors). The separation of ownership and management is also likely to occur, even though NFPs, unlike for-profits, do not have owners in the legal sense. NFPs key stakeholders include contributors and members, who may not be involved in management. Separation between management and these key external stakeholders is likely to lead to information asymmetry and thus, create a demand for GPFRs. While non-reporting entities produce SPFRs, organisations deemed reporting entities are required to produce GPFRs. The main difference between GPFRs and SPFRs is that SPFRs are prepared with limited disclosure requirements. Specifically, a SPFR must be prepared in accordance with five mandatory Australian Accounting Standards that contain mainly presentation and disclosure requirements: AASB 101 Presentation of Financial

Statements, AASB 107 Statement of Cash Flows, AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors, AASB 1031 Materiality and AASB 1048 Interpretation of Standards (Carey et al., 2014b). In addition, entities are required to apply any other Australian accounting standards deemed relevant in representing the true and fair view of the entity's financial position and performance. For example, NFPs that receive contributions may apply AASB 1004, which deals with the recognition and disclosure of contributions. In comparison, GPFRs are prepared in accordance with the suite of Australian Accounting Standards available and so, by nature contain more disclosures than a GPFR. The resulting effect is that GPFRs have more detailed financial information compared to SPFRs. Despite limited-by-guarantee companies having broadly similar legislative and financial reporting obligations under the Corporations Act as both unlisted public companies limited by shares and public companies, research indicates that around 66 per cent of companies limited by guarantee prepare GPFRs versus 34 per cent SPFRs (Carey et al., 2014a).

From July 2013 onwards, all entities (for-profits and NFPs) that are reporting entities and produce a GPFR can apply differential financial reporting requirements under AASB 1053. The basis of determination of differential reporting requirements is whether an entity has public accountability. Similar to the reporting entity concept, entities (for-profits and NFPs) self-assess whether they are publicly accountable. AASB 1053 states that entities are publicly accountable to existing and potential resource providers and others external to the entity who make economic decisions when such stakeholders are not in a position to demand reports tailored to meet their particular information needs (AASB 1053, AASB, 2010b). Though AASB 1053 provides detail on what public accountability means for for-profit entities, the standard is less clear on the application of public accountability for NFPs. For NFPs, resource providers are likely to be contributors or members that provide donations, grants and subscription fees as sources of revenue. However, caution should be applied in interpreting the meaning of public accountability for NFPs in relation to AASB 1053. This is because the term public accountability employed by AASB 1053 relates to whether resource providers are in a position to demand reports tailored to meet their particular information needs. This is very different from using 'public accountability' in layman's context to suggest that NFPs have an obligation to account for their activities and disclose their non-financial and financial performance to the wider public.

AASB 1053 establishes two tiers of reporting requirements for preparers of general purpose financial reports (GPFRs) based on the public accountability concept. Tier 1 entities include NFPs and for-profits with public accountability and all federal, state, territory and local governments. These entities are required to produce a GPFR that complies with all Australian Accounting Standards including the International Financial Reporting Standards (IFRS). Entities that are not Tier 1 are classified as Tier 2 entities and can report with substantially reduced disclosures (though they need to meet the recognition, measurement and presentation requirements of Tier 1 reporting). Accordingly, NFPs that have no public accountability are required to adopt substantially reduced disclosures under Tier 2 and cannot claim compliance with IFRS, even though measurement and recognition may be IFRS compliant (para 14, AASB 1053, AASB 2010b). In practice, approximately, 70 per cent of medium and large sized charities registered with the ACNC (regardless of legal structure) prepare a GPFR (ACNC, 2015b). Given that contributors prefer less rather than more financial information (Connolly and Hyndman, 2013a, 2013b; Connolly and Hyndman, 2003; Hyndman, 1991), it is questionable whether requiring NFPs with public accountability to prepare Tier 1 GPFRs, which contain more disclosures, is the most appropriate approach. Further, Tier 1 GPFRs do not address the additional disclosures demanded by contributors, such as financial efficiency and budget information.

Small charitable companies (ie with annual revenues less than $250,000) are not required to lodge a financial report with the ACNC (or ASIC if they are not an ACNC registered charity) (ACNC, 2016g). Medium and large charitable companies are required to self-determine whether they have existing or potential users dependent on GPFRs and may produce SPFRs if there are no users dependent on GPFRs (ACNC, 2016g). The remaining medium and large charitable companies are required to self-assess whether they have public accountability. Charitable companies with public accountability are required to produce a Tier 1, IFRS compliant GPFR. The remaining charitable companies are required to prepare a Tier 2, non-

IFRS compliant GPFR. Under both the ASIC and ACNC reporting regimes, charitable companies can lodge any of the three financial report types available to the ACNC (ie SPFR, Tier 2 GPFR or Tier 1 GPFR), provided that they are prepared in accordance with the accounting standards and present a true and fair view of the financial performance and position of the entity (Sections 296 and 297, Corporations Act 2001; Section 60.10, ACNC Regulation 2013).

In 2015, the AASB released ED270. While for-profits seek to primarily maximise profits, NFPs operate to maximise service output to beneficiaries (Johansson, 2017: AASB, 2015a). As such, financial statements currently are unlikely to adequately convey the information necessary for NFP stakeholders to make decisions regarding resource allocation. The AASB has attempted to address the limitations of financial statement reporting in the NFP sector by issuing ED270 (AASB, 2015a). ED270 recognises that stakeholders of NFPs typically demand information that enables users to assess whether a NFP has met its objectives in terms of providing goods and services for the public benefit (AASB, 2015a). The AASB refers to this type of information as 'service performance' information and defines it as "information that relates to the delivery of goods and/or services with the intention of having a positive impact on society or segments of society" (p6, AASB, 2015a). Service performance information includes information that relates to the organisation's performance objectives, inputs and outputs required to meet those objectives, outcomes from the organisation's activities, and effectiveness and efficiency in achieving organisational objectives (AASB, 201a; International Public Sector Accounting Standards Board (IPSASB), 2013). If the reporting of service performance information becomes mandatory, the AASB intends to make it applicable to all NFPs (including charities) that are reporting entities and thus, produce GPFRs (AASB, 2015a). ED270 indicates that NFP reporting entities will have much choice as to how to present service performance information (eg, it may be provided as part of the financial statements or issued separately to the annual report) (AASB, 2015a).

3. Publics' demand for efficiency information

A research team at the IPA-Deakin SME Research Centre has conducted an extensive investigation of the Australian charity sector. One of the studies conducted by Johansson et al. (2017), examines two key questions: (1) whether reforms (ie in 2010 and in 2012) to the reporting requirements for charitable companies in Australia have advanced the information needs of the public, and; (2) whether these reforms (ie in 2010 and in 2012) have influenced charities' reporting of financial and non-financial information items that the public consider important.

Johansson et al. (2017) first conducted a systematic review of legislation and regulatory guidance to compare the reporting requirements under three different regulatory regimes (pre-2010; 2010 to 2012; post 2012) and proposed reporting reform against information items identified as important to the public. Systematic review results show that over the three regulatory periods most information items deemed important by the public are not mandated, while proposed future reform seeks to mandate most items considered important to stakeholders. Reforms to date, such as the introduction of a streamlined directors' report for NFPs and the national charity regulator ACNC, therefore appear to have been influenced largely by a market approach to reporting requirements. That is, regulators are allowing charities to determine the extent of financial and non-financial information that they provide in their annual reports.

In addition to conducting a systematic review, the research team empirically tested the influence of reforms on the reporting practices of charitable companies. To achieve this objective, Johansson et al. (2017) used financial data based on a random sample of 153 Australian charitable companies limited by guarantee that lodged annual reports and AISs with regulators from 2008 to 2014 (831 charity year observations). Results from this empirical examination indicate that both regulatory reforms (being the introduction of a streamlined directors' report for NFPs and introduction of the ACNC) are positively associated with the more extensive reporting of information items that are deemed important by the public. However, when considering the information items not required by regulators, the results indicate that while the first reform (ie introduction of the streamlined directors' report) did not encourage charities to voluntarily report more information, the second reform (ie introduction of a national charity regulator) positively affected charities voluntary reporting practices.

The findings suggest that while reform has furthered the public's interest by improving the reporting of mandated and voluntary information items, it is only during the second period of reform (ie establishment of the ACNC) that charities have voluntarily reported more information items that are unregulated. One objective of the ACNC was to improve charities' accountability to the public (ACNC Act 2012). A possible explanation for the positive influence of the ACNC on charities' voluntary reporting requirements could be that charities are attempting to avoid more regulatory intervention going forward. That is, by voluntarily discharging their accountability to the public more effectively, charities can minimise scrutiny and the need for more stringent reporting requirements.

Efficiency information is frequently considered one of the most important information items that influences donation decisions (eg, Johansson, 2017; Trussel and Parsons, 2008), yet the empirical analysis shows that the reporting of efficiency information by charities has not changed over time. Findings suggest that further reform is required to ensure that charities are also reporting to the public on whether resources have been used efficiently. Johansson (2017) and Connolly and Hyndman (2013b) suggest that many charities do not report efficiency information due to concern that poor efficiency ratios will attract attention. Attention concerning poor efficiency could adversely impact perceptions regarding a charity's reputation (eg, see article concerning The Shane Warne Foundation, ABC News, 2016). This finding is also consistent with charities' current opposition to the mandated reporting of effectiveness and efficiency information proposed by ED270 (AASB, 2015a), which would enable stakeholders to better determine how charities have used their resources. The regulatory approach to efficiency information would also further the interests of other stakeholder groups, such as corporate donors and government, who are likely to want to know whether contributions have been directed to services for beneficiaries. Given charities' reservations to report efficiency information, a regulatory approach may be more appropriate than expecting that charities' will respond to market pressures to voluntarily provide the information.

Overall, Johansson et al's (2017) study provides evidence that reform to reporting requirements has adopted a primarily market perspective, whereby many of the information items that are important to the public are not mandated. A possible explanation for the current information gap between the public's information demands and reporting requirements is that regulators have been receptive to political pressures from charities that view greater mandatory reporting of financial and non-financial information as onerous. For example, charities have voiced concerns that ED270 would lead to increased compliance costs (AASB, 2015a). However, charities' opposition to mandated reporting requirements is also likely to relate to concerns that more extensive reporting could enable stakeholders, such as the public, be able to better distinguish between legitimate and illegitimate charities. In doing so, charities engaging in non-charitable activities are at risk of losing public support and/or access to tax concessions. It is therefore possible that strong lobbying from charities has outweighed the public interest and regulators have assumed a market position, even though the public may not have the power to demand the information that they need.

4. Conclusion

The IPA believes that the new reporting requirements introduced in 2012 have not achieved the desired outcomes for the public. This is not surprising as research has found that around 66 per cent of charities that are companies limited by guarantee prepare GPFRs (see Johansson, 2017; Carey et al. 2014a,b). As these reports are prepared in accordance with the full suite of Australian Accounting standards, naturally charities submitting GPFRs provide more detailed financial statements. Yet a significant proportion (34 per cent) of charities lodge SPFRs, which are based on fewer disclosure requirements, and charities submitting such reports do not necessarily follow the NSCOA. In addition, while the introduction of a national charity regulator the ACNC has encouraged charities to voluntarily report more extensive financial and non-financial information, charities generally do not voluntarily report efficiency information and provide details around their fundraising activities, which of all the information types, are particularly important to stakeholders. For example, the NSCOA outlines under the “Income 4-0000 Account” how various fundraising activities, grants and donations should be allocated and reported, yet these suggestions are not generally followed in the financial reports by charities, particularly those lodging SPFRs.

Accordingly, the ACNC should address this public need by encouraging and/or mandating that charities submit such efficiency information via, for example, more detailed expenditure items that provide greater transparency as to how charities allocate their resources as well as more information on the inputs and outputs required to meet their objectives, outcomes from the organisation’s activities, and the effectiveness and efficiency in achieving organisational objectives. Perhaps this could be achieved by the ACNC providing more guidance to charities via the NSCOA on how expenses should be categorised into different activities, which in turn could be segregated into expenses related to programs, fundraising and administration activities related to the charities’ most important programs, similar to the IRS Form 990 reporting requirements in the US.

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