



**The Institute of
Chartered Accountants
in Australia**

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

27 August 2007

Dear Sir

Re: Financial Reporting by Unlisted Public Companies

The Institute of Chartered Accountants in Australia welcomes the opportunity to make a submission on the Discussion Paper: Financial Reporting by Unlisted Public Companies.

The issue is complicated by the fact that these proposals interact with those of the AASB in ITC 12 with regard to the future of the reporting entity concept and the possible application of the proposed IFRS for SMEs in Australia. The reporting framework is consequently in a state of flux.

In our detailed response we suggest that companies limited by guarantee should continue to report to their members in some form, but that small ones (those that fall below certain thresholds) should not be required to lodge audited general purpose financial reports with the ASIC. However, we strongly recommend that some governance framework, administered by ASIC be set up to supervise these smaller unlisted public companies.

We conducted an online survey of our membership and received 48 responses. This is a high level of response to a financial reporting survey and indicates to us that there is a great deal of interest in these issues in the community. We attach a summary of the findings for your information.

Our detailed comments are attached.

Yours faithfully

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Unlisted Public Companies Discussion Paper

Companies Limited by Guarantee - Financial Reporting

A. Do you support the introduction of a differential reporting regime based on size for companies limited by guarantee? If so, what do you consider to be the appropriate criteria (both in terms of the indicators of size and the quantum of those indicators) for differentiating between those companies that are required to report and those companies that are exempt?

We do support a differential reporting regime for companies limited by guarantee. In response to our survey, just over half of those who suggested thresholds suggested using the revised small/large proprietary company thresholds brought in by the Simpler Regulatory System legislation. Feedback from participants at our Financial Reporting for SMEs forum in June, however, leads us to believe that the community as a whole would not be comfortable with removing financial reporting and audit requirements from all companies limited by guarantee that fall below that level. In addition a significant minority of respondents to our survey suggested using a lower threshold, such as revenue of \$5m, \$2m or \$1m. Of the suggestions, \$5,000,000 was the most popular.

Our suggestion is therefore a compromise approach. Based on Table 1 of the discussion paper, we suggest that companies limited by guarantee above the \$25,000,000 revenue threshold apply full IFRS (per Table 1, this is the top 5% and is likely to include those that are publicly accountable) and those below apply a specific not-for-profit standard to be formulated by the AASB. Subject to the outcome of the TTC 12 consultation process, this might be based on the proposed IFRS for SMEs. We further suggest that companies limited by guarantee with below \$5,000,000 in revenue be exempted from the financial reporting and auditing requirements of the Corporations Act in a similar manner to small proprietary companies, but be subject to enhanced corporate governance requirements. From Table 1 in the discussion paper, we can see that such a cut-off point would exempt something like 75% of the companies limited by guarantee from the requirement to prepare audited general purpose reports. We have deliberately omitted an asset test here as we are aware that some not-for-profits for historical reasons own significant assets.

We are suggesting this lower threshold in view of the cost of preparing general purpose financial information compared with the benefit for members. While there is a significant level of public interest in these entities, members are primarily focused on whether the entity is fulfilling its stated objectives, whether that be charitable work, maintaining the golf course or whatever, rather than in its detailed finances. Apart from wanting comfort that the entity can continue to operate as a going concern, most of the financial information provided in a general purpose financial report is irrelevant to the membership. Such comfort can be derived by the imposition of a rigorous governance structure.

We assume that small unlisted public companies that are exempted from financial reporting and auditing obligations would be subject to the requirement in S 347A of the Corporations Act to pass a solvency resolution within 2 months of the review date of the company, in the same way as small proprietary companies are at present. In order to be able to make such a resolution, the directors need to have a reasonable governance structure in place. Small public companies that remain unaudited (ie, without a requisition by members) should be required to demonstrate an ongoing strong governance environment. Such a governance structure could include (as suggested by one of our members) various elements, not dissimilar to the attributes that ASIC looks for in granting audit relief to large proprietary companies, for example:

- Documented governance policies
- Directors trained in governance and accredited with some minimum qualification in governance (for example, Certificate IV in Small Business Management, a qualification widely available from TAFE - see <http://www.seeklearning.com.au/tafe/certificate-4-in-small-business-management.asp>)
- A strategic plan, action/business plan and risk register, all reviewed triennially
- Policies and procedures manuals
- Annual budgets and cash flow projections
- Annual accounts, which would not be general purpose, signed by the directors, prepared within 4 months of balance date and presented to AGM of members. Such accounts would comprise a detailed profit and loss account, a cash flow statement, a balance sheet, a statement of significant accounting policies, disclosure of significant commitments and related party disclosures.
- An Annual Return, including financial data (something like the old key financial data) and confirmation of the directors' solvency resolution, signed by the directors, to be lodged with ASIC
- The option of independent audit where 5% of members requisition a meeting to appoint an auditor

This structure would be supported by a triennial review of the governance and control environment by an independent reviewer (say a Registered Company Auditor or accredited member of a review panel). Should breaches be detected in items such as:

- Governance framework and control environment
 - Triggering of a small/Large test
 - Propriety and timeliness of financial reporting to members
 - Inappropriate accessing of benefits by directors or officers (pecuniary interest or conflicted directors etc)
 - Late/no AGMs
 - Late/no financial data or annual return or equivalent lodged with ASIC,
- then that small public company should be subject to independent audit for a minimum 3 year period; the auditor would be appointed either by ASIC or by the members. Financial reports would be under, the appropriate reporting framework (perhaps the proposed IFRS for SME's, subject to the outcome of the ITC 12 consultation process) for that 3 year period.

We envisage ASIC would remain the regulator for these companies.

In our view, while the members of a company limited by guarantee may only seldom ask to see the financial report, they do at present derive some comfort from the fact that they know that one is prepared and audited. In our experience of running an auditing and financial reporting help line for the past fifteen years or so, fraud in licensed clubs (generally companies limited by guarantee) is not uncommon. Furthermore, the enquiry into the Penrith Panthers also suggested that the undisclosed accessing of benefits by directors and officers is an issue for members.

Therefore it is absolutely vital that other mechanisms need to be put in place to ensure good governance if some entities are going to be relieved of the obligation to lodge audited financial reports.

B. *Do you believe it is appropriate to differentiate between companies limited by guarantee by the nature of their operations rather than just size? If so, what nature of operations do you believe warrants greater transparency?*

74% of our respondents did not believe it is appropriate to differentiate between companies limited by guarantee by the nature of their operations rather than just size. Some constituents did, however, refer to the increased requirements for accountability where the entity has a liquor license or poker machines.

In our view, this kind of qualitative decision-making has led to confusion in the application of the reporting entity concept and in the decision as to whether an entity is in fact not-for-profit and eligible to use the not-for-profit concessions in the AASB standards. Not-for-profit reporting generally has a tight budget and the reporting regime should be kept simple to apply.

C. Do you consider that companies limited by guarantee that receive any money through grants should have financial reporting requirements? If so, can this obligation be satisfied by the company providing special purpose financial reports to the grantor rather than preparing general purpose financial reports under the Corporations Act?

The acquittal of government grants is an issue that needs to be decided in consultation with the bodies generally granting the funds. While an acquittal report designed by the department concerned and signed off by the entity's auditor is more likely to provide relevant information to the grantor body than general-purpose financial reports, if every grantor body is asking for something slightly different, it makes compilation and audit or review of the report harder for the not-for-profits and for their advisers.

Users may find it helpful if the Department of Administration and Finance, together with its State counterparts, be delegated the task of preparing a standard form of grant acquittal report for government agencies and that they liaise with the Attorney General's Department and professional accounting bodies about the accounting and auditing requirements to obtain greater uniformity and simplicity.

With the introduction of thresholds, the acquittal report becomes even more important. For those companies falling below the chosen threshold, the acquittal report will be the only means the grantor has of assessing that the funds have been used appropriately.

D. If you support some companies limited by guarantee being exempted from financial reporting, what percentage of members should be required in order to require an exempt company limited by guarantee to prepare a financial report?

Our survey revealed roughly equally strong support for the following percentage cut-off points: 5%, 10%, 25% and 75%. Our view is that 5% of members (in line with S 293 of the Corporations Act) or 100 members in number, whichever is lower, should be able to require a company limited by guarantee that falls below the lower threshold to prepare a financial report.

This requirement must, however, be supported by a strong commitment from the regulator to take an interest in the affairs of companies that fall below the threshold. Anecdotal evidence from our help line indicates that the provision in the Corporations Act enabling holders of 5% of a small proprietary company to demand financial reports can be ineffective where there is a falling out between shareholders. We have heard of instances where shareholders without the resources to pursue legal remedies are ignored by the majority owners when they request financial reports. When they complain to ASIC about the contravention of the Corporations Act, they receive no support. When a dispute between members arises, the majority or the individuals more concerned with day-to-day management may often be in a position to draw on company funds to pay legal expenses, whereas private individuals have to put in their own

money. Commencing legal action is very costly and private members can be effectively deprived of their rights if they cannot afford to pay to have them enforced.

E. *If you support the retention of financial reporting requirements for all companies limited by guarantee, do you consider that there is scope to reduce the amount of financial information these companies are required to report? If so, what type of financial information do users need companies limited by guarantee to report (for example, related-party disclosures)?*

See our answer to A above.

To some extent, the answer to this question must depend on the outcome of the AASB's consultation on ITC 12. We suggest that companies limited by guarantee with revenue between \$5,000,000 and \$25,000,000 be able to use IFRS for SMEs (tailored for not-for-profits) if it is issued for use in Australia instead of full IFRS, should they wish. For the time being, under the current reporting framework, or if the proposals in ITC 12 do not gain acceptance, companies limited by guarantee that are non-reporting entities and fall between these two thresholds should be able to continue to prepare simplified accounts.

F. *Do you consider that there is a need to harmonise the financial reporting requirements of companies limited by guarantee and incorporated associations to provide a consistent reporting framework for not-for-profit entities in Australia?*

We wholeheartedly agree with this proposition. Work done by our Not-for-profit Group in Victoria has demonstrated the wide variety of requirements that not-for-profits are subject to around Australia – see <http://www.charteredaccountants.com.au/files/documents/ICAA07-SSASubmission042707.pdf>. As time passes, Australia acts more and more as one single economy and a not-for-profit may have branches in every state. It would be of considerable assistance to our members and their clients if the requirements were harmonised.

We note the view recently expressed by David Gonski in “Company Director” August 2007 that a special not for profit corporate entity be established to replace companies limited by guarantee and associations, under powers referred to the Commonwealth by the States. This suggestion is, in our view, worthy of further investigation.

G. *In order to assist in progressing this project, it would be useful to obtain an indication from companies limited by guarantee of the cost of preparing a directors’ report and audited financial report as required by the Corporations Act.*

We are unable to provide this information, but are publicising the paper to our members who may be able to assist you. We have heard estimates ranging from \$7,500 to \$60,000.

Companies Limited by Guarantee - Auditing

H. *If some companies limited by guarantee were to be exempt from financial reporting, do you consider there is value in these companies continuing to be subject to some level of non-statutory external assurance as a means of promoting good governance? If so, what should this assurance relate to and how do you think this regime should be introduced (for example, through best practice guidelines issued by the professional accounting bodies)?*

In our view, companies limited by guarantee that are required to prepare and lodge general-purpose financial reports should have them audited.

Those companies that fall below the threshold and are not required to lodge general-purpose financial reports should be subject to a governance regime similar to that used by ASIC in its

audit relief Class Order (see A above). Under that Class Order, large proprietary companies can be excused from having an audit if a suitably qualified accountant certifies that appropriate governance practices are in place.

In light of the shortage of registered company auditors in country areas, we suggest that the governance review described in A above should be able to be performed by a member of the accounting bodies with a practicing certificate.

In order to safeguard the public interest, regulation for those companies limited by guarantee that fall below the lower threshold should still be statutory.

- I. *For those companies limited by guarantee that are required to prepare financial statements, do you consider that there is a need to change the current audit requirements? If so, which aspects of the current requirements need to be reformed?*

In our view, the current audit requirements are satisfactory for those companies limited by guarantee that are above our lower threshold and are therefore required to prepare financial statements.

Companies Limited by Guarantee - Other issues

- J. *Do you support amending the Corporations Act so that companies limited by guarantee are specifically prohibited from distributing profits to members in the form of dividends?*

We were not aware that there was any demand for the legislation to be changed in this way, but we have no objection to such a change being made.

Unlisted Companies Limited by Shares

- K. *Do you support the principle that all for-profit companies that have raised capital from the public should have statutory annual financial reporting obligations?*

We support this principle.

- L. *Given a satisfactory mechanism to allow unlisted public companies limited by shares with a not-for-profit objective to convert to a company limited by guarantee is not available, would you support an equivalent differential reporting regime to that proposed for companies limited by guarantee to be established for unlisted public companies limited by shares with a not-for-profit focus? If so, do you support using the definition of not-for-profit entity in the accounting standards to determine whether a company has a not-for-profit focus?*

We question how many companies limited by shares with a not-for-profit objective there are and therefore how necessary this proposal is.

We also have reservations about this proposal as the definition of not-for-profit in the accounting standards is interpreted differently from practice to practice. However, if, as is proposed, the AASB drafts a more rigorous definition with supporting commentary, we would support this proposal.

M. In order to assist in progressing this project, it would be useful to obtain an indication from unlisted public companies limited by shares of the cost of preparing a directors' report and audited financial report as required by the Corporations Act and also the number of unlisted public companies limited by shares that have a not-for-profit objective.

We are unable to provide this information, but are publicising the paper to our members who may be able to assist you.