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By email: UPCcomments@treasury.gov.au

Dear Mr Miller

Financial reporting by public unlisted companies

CSA is the peak professional body delivering accredited education and the most practical and authoritative training and information on governance, as well as thought leadership in the field. Our members are all involved in governance, corporate administration and compliance with the *Corporations Act* (the Act). Many of our members work for public unlisted companies, or serve as officers of not-for-profit organisations, or manage the affairs of subsidiary companies of public listed companies, which are frequently public unlisted companies. We have drawn on their experience in the formulation of each submission on the matters contained in the Consultation Paper.

General comments

CSA welcomes the discussion paper *Financial Reporting by Public Unlisted Companies* and its focus on ameliorating the regulatory burden, particularly on smaller public unlisted companies and those in the not-for-profit sector. CSA fully supports the proposal to introduce threshold tests to determine which public unlisted companies should be subject to full reporting requirements and which companies could be exempt from such requirements.

CSA also notes that the essence of good governance is accountability, transparency and stewardship, and that any reform of the financial reporting framework for public unlisted companies must balance the reasonableness of compliance requirements, particularly for smaller companies, with the need to ensure that stakeholders continue to have confidence in the governance of such companies.

On this basis, CSA does *not* support the proposed Australian Accounting Standards Board (AASB) small and medium entity (SME) standard, which CSA believes will impose a significant and expensive regulatory burden on small public unlisted companies for no benefit to stakeholders and at great unnecessary expense.

CSA recommends that thresholds be introduced for public unlisted companies in relation to financial reporting requirements (see below) but **rejects** the proposed AASB SME standard as the basis for such a regime.

CSA also opposes the elimination of the 'reporting entity' approach to determining the application of accounting standards. In the absence of any evidence of abuse or problem with the 'reporting entity' concept, CSA queries why the AASB promotes its removal.

CSA also notes that the discussion paper does not discuss one group of companies that are both companies limited by guarantee and companies limited by shares. CSA notes that such companies, while perhaps few in number, nonetheless need to be considered in any process of reform. Most recently this group would include financial organisations, which came under the jurisdiction of the corporations law in 1999. The group of companies that were both limited by guarantee and shares (for example, friendly societies) took the once-off opportunity to elect this form of incorporation in order to provide them with the option, at a later date, of undertaking a process of demutualisation with diminished difficulty.

Proposed AASB SME standard

CSA notes with concern that the discussion paper refers to the differential reporting regime proposed by the AASB, which proposal would negate the impetus to provide relief to smaller public unlisted companies and those in the not-for-profit sector as outlined in Treasury's discussion paper.

Under the proposed AASB revised differential reporting regime, the application of AASB standards would no longer depend on whether entities are reporting entities; rather the focus of application would be general purpose financial reports. Accordingly, all entities that prepare general purpose financial reports would apply either the Australian equivalents to IFRSs or an Australian equivalent to the IFRS for SMEs, based on criteria that establish which set of these standards would apply.

The revised differential reporting regime proposed by the AASB would replace the 'reporting entity' approach to determining the application of accounting standards. Currently almost all not-for-profit companies can select not to be reporting entities and therefore need only produce 'special purpose accounts'. CSA notes that many not-for-profit companies, particularly larger ones, choose to produce full accounts for a variety of reasons beyond the scope of this submission. The important issue is that not-for-profit companies currently have a choice to select 'special purpose accounts', which choice brings with it a significantly reduced reporting requirement and consequential potential for savings.

The new SME standard proposed by the AASB will force all small not-for-profit companies to comply with the new SME reporting standard, which carries considerably greater reporting requirements than the current 'special purpose accounts'. As a result, small not-for-profit companies will incur significantly greater costs in order to produce financial reports, for no benefit to their stakeholders. Members of not-for-profit companies, as noted by the discussion paper, are not investors seeking to examine the accounts to ascertain the deployment of and return on their investment.

CSA is also concerned that any acceptance of the SME standard proposed by the AASB has the capacity to change the current reporting requirements of small proprietary companies. The *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007*, enacted in June 2007, defines a proprietary company as large if it satisfies two of the following tests: revenue of $25 million; assets of $12.5 million and 50 employees, with future changes to thresholds prescribed by regulations. Those companies that do not meet two of these three threshold tests are classified as small proprietary companies and are exempt from statutory financial reporting.

The introduction of the proposed SME standard could alter this situation and impose a regulatory burden on small proprietary companies. The AASB Exposure Draft says that:

> "the proposals would not affect small proprietary companies. However, if they prepare and lodge financial reports (such as when the ASIC directs them or they are controlled by a foreign company, or 5% of shareholders require them), they would be required to apply an Australian equivalent to the IFRS for SMEs; and large proprietary companies would apply the Australian equivalents to IFRSs if they exceed either of the nominated size thresholds for important for-profit entities, or an Australian equivalent to the IFRS for SMEs if they fall below those thresholds, because they produce general purpose financial reports as a result of having to lodge their financial reports on a public register."

Connected to this potential regulatory imposition is the fact that, at present, large proprietary companies have the option of producing 'special purpose accounts'. The AASB proposals could force all large proprietary companies to produce full financial reports, as a large public listed company may have a number of subsidiaries, of which a certain number could be large proprietary companies. Such an outcome would negate the recent reform of financial reporting for proprietary companies.

A further consequence of accepting the AASB standards as laid out in the *Exposure Draft A Proposed Revised Differential Reporting Regime for Australia and IASB* is that a public company may have subsidiaries that are also public companies. As subsidiaries, the public companies currently only need to produce 'special purpose accounts'. The proposed new standard will force such companies to produce full financial accounts.

CSA is strongly opposed to the proposed AASB standard, which would impose financial reporting requirements on proprietary, public unlisted and not-for-profit companies, for no benefit to stakeholders and at great unnecessary expense.

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?

CSA agrees that many companies limited by guarantee are small not-for-profit organisations operating for the benefit of members (for example, small sporting clubs), and that, for such companies, the requirement to apply the same reporting and auditing regime that applies to public listed companies imposes a severe regulatory burden. The members of such companies want to know the financial position of the company and that the company is being managed well, but the current full level of statutory reporting does not fulfil this need. Members rely on internal reports to gain an understanding of the financial position of the company. The reporting requirements under the Corporations Act are onerous for companies limited by guarantee, yet do not provide member benefit.

CSA believes that financial reporting requirements for companies limited by guarantee should be based on size. Such a differential reporting regime currently operates for proprietary companies. A proprietary company must meet two out of three thresholds in order to gain relief from financial reporting requirements. CSA believes that this differential reporting regime for proprietary companies, based on threshold tests concerning revenue, assets and employee numbers, works well. However, CSA does not believe that the same threshold tests can be applied to public unlisted companies.

CSA recommends that threshold tests of $1 million in revenue and $1 million in assets be used to determine the applicability of financial reporting requirements to companies limited by guarantee. CSA further suggests an added threshold test to protect charities that may possess small classes of assets that may have been donated to them. Thus, if a company limited by guarantee meets both threshold tests, they are captured automatically in the financial reporting requirements. If a company limited by guarantee meets one out of the two threshold tests (for example, less than $1 million in revenue but $1.8 million in assets) then the second threshold test rises to $2 million before the automatic capture of the company in financial reporting requirements. CSA notes that, according to the discussion paper, the use of $1 million in revenue as a threshold provides relief to 68 per cent of companies limited by guarantee. All companies limited by guarantee that do not meet these threshold tests would be automatically exempted from statutory financial reporting. CSA agrees that employee numbers should not be used as a threshold test, due to the prevalence of volunteer labour in the not-for-profit sector.

CSA also recommends that a specialised accounting standard be introduced for not-for-profit companies limited by guarantee with revenue between $1 million and $25 million. Such companies would also be subject to an audit review rather than a full audit (see below).

CSA recommends that all companies limited by guarantee with revenue over $25 million be subject to full financial reporting requirements.

CSA strongly recommends that the reporting entity concept be retained and that not-for-profit companies, both large and small, continue to be able to produce special purpose accounts. CSA is strongly opposed to the use of the AASB proposal for a SME standard as the base of a differential reporting regime, which would remove the current special purpose financial reports. CSA believes that the proposed SME standard will negate the intention, as laid out in the discussion paper, to provide relief for small not-for-profit companies.

Finally, CSA notes that companies that are either exempt under this proposal from financial reporting requirements or captured by a purpose-built not-for-profit accounting standard may have statutory reporting obligations under other legislation, such as the Charitable Fundraising Act 1991 (NSW) and that these would remain unchanged.

B Do you believe that 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?

As noted above, CSA supports the introduction of a differential reporting regime based on size, which is an objective measurement when based on revenue, assets and employee numbers. Such a differential reporting regime would need to be based on the current definitions of ‘reporting entity’ and ‘special purpose financial reports’ and *not* on the SME standard proposed by the AASB.

However, CSA does not support differentiating between companies limited by guarantee based on the nature of their operations.

Attempting to differentiate between companies limited by guarantee based on the nature of their operations both provides opportunity for abuse and manipulation, and the unintended consequences of companies that need to report no longer being required to do so. There is no common denominator for determining the nature of operations of companies limited by guarantee.

While companies raising funds through donations from the public may warrant greater transparency, such operations can still be accounted for under the size test. CSA believes that it would be impossible to draft legislation that would consistently and accurately define the nature of operations that would accommodate different purposes, without creating unintended consequences.

CSA recommends that companies limited by guarantee *not* be differentiated by the nature of their operations rather than just by size.

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?

Companies limited by guarantee that receive grants need to report to the funding body or grantor against a set of conditions attached to the grant. The companies usually need to show that they have fulfilled the conditions of the grant, or achieve a set of key performance indicators upon which the grant rests. To require companies limited by guarantee to prepare general purpose financial reports under the Corporations Act as well as to report against a set of conditions attached to the grant would simply impose a new level of regulatory burden on companies limited by guarantee. Such general purpose financial reports under the Corporations Act would not assist companies limited by guarantee in reporting against the conditions attached to their grants.

CSA recommends that any financial reporting obligations to funding bodies or grantors for money received through grants by companies limited by guarantee be satisfied by the company providing financial reports and agreed information to the grantor and *not* by preparing general purpose financial reports under the Corporations Act.

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?

CSA recommends that an exempt company limited by guarantee should be required to prepare financial reports in accordance with the Corporations Act if the lesser of 100 members or five per cent of voting members requests it to do so.

CSA notes that this requirement could be based on s 293 of the Corporations Act, which allows shareholders to nominate the information they would like to receive and whether the information is to be audited.

CSA also recommends that ASIC be able to request a company limited by guarantee to prepare financial reports.

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)?

CSA *does not* support the retention of financial reporting requirements for all companies limited by guarantee.

CSA supports the principle of a SME standard being introduced that will assist to reduce the amount of financial information that a smaller company limited by guarantee would be required to report. However, CSA does not support the proposed AASB SME standard. This standard has been developed for listed companies operating in capital markets and is not applicable to companies limited by guarantee, many of which are not-for-profit.

The purpose of IFRS, including the proposed SME standard, is to standardise accounting across jurisdictions, both to ease reporting for companies operating across jurisdictions and the analysis of financial reports in different accounting jurisdictions. However, not-for-profit companies are not international companies. The introduction of a standard international reporting framework for the not-for-profit sector would considerably increase the cost of preparing financial statements for smaller companies without any significant benefit to the companies or their stakeholders.

CSA suggests that a separate not-for-profit disclosure standard should be developed for Australia by the AASB and the current AASB SME standard be modified to reflect specific not-for-profit disclosure. Large not-for-profit companies limited by guarantee could utilise this yet-to-be-modified SME standard regardless of size. CSA notes that, regardless of the amount of financial information companies limited by guarantee should be obliged to report, there should be an obligation on the directors to prepare financial statements that are meaningful and do not omit material information.

CSA recommends that the current reporting of special purpose accounts is sufficient disclosure for not-for-profit companies. The stakeholders of companies limited by guarantee should be determining whether general purpose or special purpose financial reports are required.

CSA also recommends that related-party disclosures *must* be included in any financial information companies limited by guarantee are required to report.

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?

CSA recommends that consistent standard for reporting obligations apply across the Corporations Act and the state-based legislation for unincorporated associations. Every company, no matter where it is registered in Australia, should apply the same rules and every not-for-profit organisation should be treated in the same manner.

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.

CSA believes that the amount quoted in the Simpler Regulatory System Bill (Chapter 9 of the Explanatory Memorandum) of around $60,000 for a large proprietary company would be a reasonable indicator of the cost for a company limited by guarantee to produce a financial report. CSA also believes that such reports would cost considerably more if prepared on an

IFRS for SMEs basis (that is, as a general purpose financial report). CSA believes an additional cost of $40,000 could be involved for small companies limited by guarantee, as applying this standard would mean that companies would need to produce additional information. The additional costs would arise as a result of the need to:

- use external accountants
- increase the level of audit
- increase the production costs associated with the annual report.

CSA notes that many smaller companies limited by guarantee would not have the employee resources to prepare financial reports as required under the Corporations Act and would therefore have to outsource such reporting. All costs associated with preparing financial reports, such as printing, mailing, auditing and the human resource costs of accounting, administration and publishing, would affect the bottom line for smaller companies,.

Audit requirements

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)?

CSA recommends that threshold tests of $1 million in revenue and $1 million in assets be used to determine the applicability of financial reporting requirements to companies limited by guarantee.

On this basis, CSA recommends that:

- for companies under the threshold of $1 million in revenue and it would be left to the stakeholders to determine the type of reporting and assurance required
- companies with between $1 million and $25 million in revenue would be subject to an audit review (see below)
- companies with revenue over $25 million would be subject to a full audit.

An audit review would not provide an opinion, but would review the financial statements and internal controls, that is, those areas of risk in a company.

CSA recommends the introduction of an audit review for companies with revenue between $1 million and $25 million.

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?

CSA strongly supports audits, as our members believe that audits ensure that companies remain transparent and accountable to all stakeholders.

CSA recommends that threshold tests of $1 million in revenue and $1 million in assets be used to determine the applicability of financial reporting requirements to companies limited by guarantee.

On this basis, CSA recommends that:

- for companies under the threshold of $1 million in revenue and it would be left to the stakeholders to determine the type of reporting and assurance required
- companies with between $1 million and $25 million in revenue would be subject to an audit review (see below)
- companies with revenue over $25 million would be subject to a full audit.

An audit review would not provide an opinion, but would review the financial statements and internal controls, that is, those areas of risk in a company.

CSA recommends the introduction of an audit review for companies with revenue between $1 million and $25 million.

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?

CSA notes that any such prohibition would pose difficulties for the group of companies that are both companies limited by guarantee and companies limited by shares, which are discussed at the start of this submission.

In the absence of any evidence of abuse or problem, CSA cautions that any legislative reform needs to consider the needs of the group of companies that are both companies limited by guarantee and 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?

While companies that are raising money from the public need at the time of fundraising to provide sufficient financial information so that they can attract capital, Table 2 of the Discussion Paper on page 3 clearly indicates that most of the unlisted public companies limited by shares are clearly economically insignificant (44 per cent have revenues of $1 million or less), and few meet the recently amended size threshold revenues and assets tests for large proprietary companies.

CSA does not therefore support the principle that all for-profit companies that have raised capital from the public should have statutory annual financial reporting obligations.

CSA recommends that the same threshold tests as recommended by us for companies limited by guarantee apply to companies limited by shares to determine the applicability of financial reporting requirements, that is, threshold tests of $1 million in revenue and $1 million in assets.

CSA also recommends that five per cent of shareholders in companies exempt from reporting obligations have the right to require the company to prepare financial reports, and can nominate the information they would like to receive and whether the information is to be audited.

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?

CSA recommends that the same threshold tests as recommended by us for companies limited by guarantee apply for companies limited by shares to determine the applicability of financial reporting requirements, that is, threshold tests of $1 million in revenue and $1 million in assets.

CSA notes that the Accounting Standards definition of not-for-profit classifies a not-for-profit as a company that does not pay tax. CSA points to the fact that mutual organisations pay tax on income they do not earn from members, even though non-member income may be much smaller than member-income. It is important that this fact does not render mutual organisations ineligible for not-for-profit status.

CSA recommends using the definition of not-for-profit entity in the accounting standards to determine whether a company has a not-for-profit focus, regardless of whether the entity is a company limited by guarantee or a company limited by shares. However, CSA points to the accounting standards not-for-profit definition of not paying tax as potentially causing difficulties.

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.

CSA believes that the amount quoted in the Simpler Regulatory System Bill (Chapter 9 of the Explanatory Memorandum) of around $60,000 for a large proprietary company would be a reasonable indicator of the cost for a company limited by guarantee to produce a financial report. CSA also believes that such reports would cost considerably more if prepared on an IFRS for SMEs basis (that is, as a general purpose financial report). CSA believes an additional cost of $40,000 could be involved for small companies limited by guarantee, as applying this standard would mean that companies would need to produce additional information. The additional costs would arise as a result of the need to:

- use external accountants
- increase the level of audit
- increase the production costs associated with the annual report.

CSA notes that many smaller companies limited by guarantee would not have the employee resources to prepare financial reports as required under the Corporations Act and would therefore have to outsource such reporting. All costs associated with preparing financial reports, such as printing, mailing, auditing and the human resource costs of accounting, administration and publishing, would affect the bottom line for smaller companies.

Conclusion and recommendation

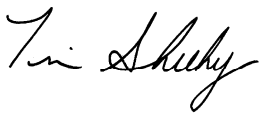
CSA has given careful consideration to the issues raised by the discussion paper on financial reporting by unlisted public companies.

CSA strongly recommends that thresholds be introduced for public unlisted companies in relation to financial reporting requirements, but rejects the proposed AASB SME standard as the basis for such a regime.

CSA also opposes the elimination of the 'reporting entity' approach to determining the application of accounting standards.

CSA would welcome further contact during the consultation process and the opportunity to be involved in further deliberations.

Yours sincerely



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