FINANCIAL FUNDAMENTALS FOR NOT-FOR-PROFIT DIRECTORS

S. Dianne Azoor Hughes

Australian Institute *of* Company Directors

The Australian Institute of Company Directors is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 44,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

Print edition published August 2019
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Text design Kirk Palmer Design
Printed by Ligare

NATIONAL LIBRARY OF AUSTRALIA

A catalogue record for this book is available from the National Library of Australia

Title: Financial Fundamentals for Not-for-Profit Directors
ISBN: 9781876604738

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Foreword

The not-for-profit (NFP) sector is a critically important component of Australia's society and economy. It employs over a million people and delivers services to millions more, many of whom are disadvantaged.

Recent royal commissions mean that governance is in the spotlight like never before. These commissions have increased community expectations of leaders of all organisations, including those in the NFP sector. These leaders, whether they be directors, committee members or executives, are expected to have clear oversight of all aspects of their organisation, including its financial health.

The Australian Institute of Company Directors has published the *NFP Governance and Performance Study* since 2010 and it has shown that directors are spending increasing amounts of time in their governance role to match these expectations. Importantly, the study notes that not all NFP directors are comfortable or confident in the oversight of financial statements despite the need for NFPs to be financially sustainable.

Financial Fundamentals for Not-for-Profit Directors is a timely resource to assist all NFP directors to develop their financial literacy and gain a firm understanding of key aspects of financial statements.

S. Dianne Azoor Hughes offers some excellent background on the NFP sector and goes on to examine the fundamentals of accounting and accounting frameworks. Chapters on special considerations for charities, measuring the value of transactions and the types of statutory reports provide specific information of critical importance to the NFP sector. The section of questions to consider when reviewing financial statements is an invaluable practical resource, and of even greater benefit is the link back to the various chapters where relevant information is held.

Dianne wisely notes that this publication does not eliminate the need to consult with an expert when there is complexity or uncertainty in the accounting, however it does provide valuable insights that makes the responses to such consultation much easier to understand.

In early 2019, the Australian Institute of Company Directors published a new edition of *Not-for-Profit Governance Principles*, which reflects on the role of the board to oversee appropriate use of the organisation's resources and monitor the solvency of the organisation. NFP directors will be able to meet these *Principles* more effectively with the assistance of *Financial Fundamentals for Not-for-Profit Directors*, and I congratulate S. Dianne Azoor Hughes on this publication.

Phil Butler GAICD CPA
Sector Leader, Not-for-Profit, Australian Institute of Company Directors

Acknowledgements

This publication focuses on financial literacy. It aims to promote an understanding of financial reporting language and its meaning and, in so doing, to assist not-for-profit (NFP) directors in discharging their financial governance responsibilities. However, the NFP sector in Australia is large and diverse and scoping financial fundamentals across the sector needs a careful balance. I would like to express my sincere thanks to Jennifer Lambert FAICD, Rosina Hislop FAICD and Phil Butler GAICD for their time in reviewing the draft of *Financial Fundamentals for Not-for-Profit Directors*. I am grateful for their comments and insights, which prompted both deeper reflection and amendments in the final publication.

I also thank my publisher, Javier Dopico GAICD, for his suggestions and advice throughout the development of this publication.

Chapter 1

Financial literacy and governance

1.1 Introduction

The not-for-profit (NFP) sector is both large and diverse and in the last decade its significance to the Australian economy has been recognised. In 2010, the Australian Government Productivity Commission released the *Contribution of the Not-for-Profit Sector: Productivity Commission Research Report*.[1] This research reported that there were more than 600,000 NFP organisations at that time, of which approximately 59,000 were deemed economically significant.[2] In 2012, the Australian Charities and Not-for-profit Commission (ACNC) was established as the national regulator of charities. The review of the ACNC legislation *Strengthening for Purpose* (2018)[3] includes references back to the 2010 Research Report, to build on that previous review. It records that currently there are approximately 56,000 charities registered with the ACNC. These numbers indicate that more than 90 per cent of NFP organisations in Australia exist for community and social impact rather than charitable purpose.[4]

1 Australian Government Productivity Commission, 2010, *Contribution of the Not-for-Profit Sector: Productivity Commission Research Report*, January, Commonwealth of Australia, https://www.pc.gov.au/inquiries/completed/not-for-profit/report/not-for-profit-report.pdf, (accessed 5 February 2019).

2 Ibid p xxiii.

3 P McClure, G Hammond, S McCluskey and M Turnour, 2018, *Strengthening for Purpose: Australian Charities and Not-for-profits Commission Legislation Review: Report and Recommendations*, May, Commonwealth of Australia, https://static.treasury.gov.au/uploads/sites/1/2018/08/p2018-t318031.pdf, (accessed 5 February 2019).

4 Australian Charities and Not-for-profits Commission, *Charitable purpose*, [website], http://edit.acnc.gov.au/for-charities/start-charity/before-you-start-charity/charitable-purpose, (accessed 5 February 2019).

In Australia, NFP organisations include public sector and government agencies, charities, cooperatives, clubs and associations. Given the diversity of the NFP sector, NFPs range from small community groups with limited resources and a significant reliance on volunteers, to large national organisations with experienced boards and professional paid management and staff. Larger, mature NFPs have well-established governance practices and procedures akin to large public companies.

Public accountability will vary between different NFP organisations depending on the type of NFP, its location and relevant local legislation, its constitution, the size of the NFP and its purpose. Similarly, accountability to those providing funding regarding how funds are discharged may vary: reporting to those providing funding may be mandated in legislation, the constitution and/or in funding agreements. However, the duties and obligations regarding financial management of any NFP are the same, albeit the size of amounts involved and the complexity of operations may differ. NFP directors must focus on the NFP's need for funding and the use of those funds in pursuit of the NFP's purpose. This publication relates to the general financial obligations of each type of entity and not specific compliance obligations, recognising that non-financial data is also likely to be an important element of effective financial management.

The label 'not-for-profit' raises mixed responses as a suitable description of the sector. The term is intended to signify that the primary motive of the entity is not a concern with earning a return for shareholders. However, a 'not-for-profit' organisation could equally be referred to as a 'not-for-loss' or 'for-purpose' organisation, as any NFP organisation that incurs losses in pursuit of its objectives will not be sustainable. The responsible officers of NFPs will need to have a level of financial literacy, sufficient to be able to discharge their financial governance duties to ensure the NFP remains financially viable.

For ease of reference, the term 'NFP' will be used in this publication to refer to any legal structure representing an NFP, and the terms 'NFP board' and 'NFP director' will be used to refer to the governing body and roles of responsibility in any NFP legal structure, including committee and committee members, council and councillors, office and officers, commission and commissioners.

1.2 Acceptance of a role as a board member of an NFP

When a nominee is invited to join an NFP board, a primary motive for considering the role is likely to be an interest in the organisation's social purpose. The organisation's potential to achieve its purpose will be supported by information in its constitution (or equivalent rules) and the most recent annual financial report. As with any appointment to a for-profit board, appointment to an NFP board can bring both financial and reputational risk if the individual does not fully appreciate the responsibilities that come with the role.

The constitution will provide a basic outline of the NFP's governance, including its financial governance structure. The financial report will provide a deeper insight into the NFP's performance and areas of both operational and financial risk over the preceding two years. To make an informed decision to accept or decline an offer to join an NFP board, a prospective director will have to assess the NFP's financial report. A prospective director needs to be able to read and understand a financial report to evaluate whether the underlying risks are acceptable in making a decision whether or not to join the board. The decision to accept or decline an NFP board position is likely to present the first point of contact with an NFP's financial report; this information provides context for financial responsibilities in a future role as a director of that NFP.

In general terms, 'financial literacy' refers to the skills and knowledge that enable informed and effective decisions to be made about the use of financial resources. An individual is generally required to have a level of financial literacy sufficient to manage their income and expenses, to protect any assets acquired and to pay their bills when they fall due. The level of financial literacy expected of all directors is much higher than in the general population. A director of an NFP organisation is expected to have a level of financial literacy that is commensurate with the operational and financial risks of that NFP.

NFP directors need to consider whether they have the appropriate skills and expertise to balance risk effectively and drive performance, to be able to establish financial management practices appropriate for the NFP's particular circumstances. Understanding risk management includes financial literacy as it enables an NFP director to steer the activities of the NFP through both years of surplus funding and years when funding is curtailed.[5]

For example:

- The operational and financial risks of an NFP that is dependent on donations from supporters to fund its activities each year are very different to those of an established NFP that carries a portfolio of investments from which it derives a significant portion of its income to fund its operations.
- If an NFP operates in different states in Australia, directors need a level of financial literacy that includes an understanding of the differing regulatory requirements for each state in which the NFP operates. For example, in respect of fundraising:
  - Although the ACNC is working to remove fundraising registration requirements for registered charities, other NFPs will continue to be required to comply with the state-based fundraising registration requirements. This means understanding whether a registration for fundraising is needed in each state before a national public appeal is launched, and the fundraising reporting that may be required by the local fundraising regulator, pursuant to the relevant state legislation each year.
  - Understanding the availability of local grants and resources which require funding applications to be submitted.

NFP directors should have an appropriate level of financial literacy to meet their legislative responsibilities, understand the NFP's financial information needs and recognise when consultation with a financial expert is needed. At a very basic level, NFP directors need a clear understanding of the differences between a surplus/deficit, cash flow and going concern. Monitoring cash flow is often the primary concern for NFP directors. In particular, however, NFP directors also need to understand that, unlike cash, a surplus/deficit is not an absolute number and will be impacted by the accounting rules applied for financial reporting purposes.

5 A nominee for a not-for-profit (NFP) board is likely to need a different perspective of financial governance practices to a director of a for-profit company. Financial literacy for for-profit directors is considered in the separate publication, D Azoor Hughes, 2019, *Financial Fundamentals for Directors*, 2nd edition, AICD.

1.3 Financial reporting by NFPs

The legislation and regulation that an NFP needs to comply with for financial reporting will be different depending on its legal structure, its size and the state or territory in Australia where the NFP is established. As reported by the Productivity Commission in 2010,[6] legal structures of NFPs at that time comprised:

- companies limited by guarantee (11,700)
- incorporated associations (136,000)
- cooperatives (1,850)
- NFPs incorporated by other means (9,000, including approximately 2,500 Indigenous corporations)
- unincorporated entities (440,000)

These different legal structures indicate that the legal directives applicable to NFPs and their directors will be as diverse as the sector and will comprise both Commonwealth and state legislation and regulation.

All NFP organisations that engage in any financial transactions will have financial reporting responsibilities. The list below provides examples of legislative and regulatory sources for financial reporting, depending on the type of NFP:

- Financial reporting requirements for companies limited by guarantee are set out in the *Corporations Act 2001* (Cth).
- Financial reporting requirements for incorporated associations and cooperatives are set out in the relevant state legislation, which is specific to the state in which the NFP is established.
- An unincorporated association is not recognised as a separate legal entity to the members associated with it but is considered an entity under tax law and treated as a company for income tax purposes.[7] Financial statements will be required for taxation purposes.

6 Australian Government Productivity Commission, 2010, op cit.

7 The Australian Tax Office offers guidance on not-for-profit (NFP) entities at *Overview of legal structures*, [website], https://www.ato.gov.au/Non-profit/Getting-started/In-detail/Registration/Overview-of-legal-structures/, (accessed 5 February 2019).

- Financial reporting for public sector agencies is set out in state legislation. For example, a public sector agency in Victoria prepares financial statements in accordance with the *Financial Management Act 1994* (Vic).
- Private ancillary funds are established under a will or instrument of trust, as valid under state or territory law and operate and prepare financial statements in accordance with the *Income Tax Assessment Act 1997* (Cth) and the *Private Ancillary Fund Guidelines 2009* (s 26).
- Public ancillary funds are established in accordance with the model trust deed relevant to the state or territory as advised by the Australian Taxation Office (ATO),[8] which includes requirements for preparing financial statements and audit.
- Churches and religious institutions previously registered as charities by the ATO were automatically transferred to the ACNC and therefore comply with ACNC reporting requirements.

In addition to these different reporting obligations, the NFP sector is diverse in terms of purpose, legal structure, size and resources. Each of these four criteria also may drive different reporting responsibilities.

Purpose

Purpose includes the objectives of the NFP set out in its constitution, rules, charter or the legislation by which the NFP is established. The purpose or nature of the NFP's activities is likely to include reporting obligations.

For example:

- Charities report to the ACNC.
- State trade or professional bodies may report to a national body.
- Reporting for segments such as health or education may report to an industry body.

8 The Australian Tax Office offers information on model trust deeds at *Public ancillary fund model trust deed*, [website], https://www.ato.gov.au/forms/public-ancillary-fund-model-trust-deed/, (accessed 5 February 2019).

Legal structures

Legal structures include public sector entities established by legislation, companies limited by guarantee, associations incorporated under state legislation, cooperatives, and other unincorporated associations, clubs and groups. When the legal structure of the NFP is established in accordance with legislation, the legislation will include reporting obligations for those responsible for the organisation's activities.

For example:

- The statutory responsibilities of companies limited by guarantee are set out in the *Corporations Act 2001* (Cth).
- The statutory responsibilities of an association incorporated in Victoria are set out in the *Associations Incorporation Reform Act 2012* (Vic).
- The statutory responsibilities of an association incorporated in New South Wales are set out in the *Associations Incorporations Act 2009* (NSW).
- The statutory responsibilities of statutory authorities and committees are set out in the legislation under which the entity is established.

Size

Size ranges from small, local activities, to state-based operations, to operations with national and international impact. The statute governing legal structure is likely to include differential reporting requirements depending on size.

For example:

- Size criteria apply to companies limited by guarantee to determine the extent of reporting obligations arising in accordance with the *Corporations Act 2001* (Cth).
- Size criteria apply to charities defined as small, medium or large for financial reporting lodgments with the ACNC.
- Size criteria apply to associations incorporated in Victoria as set out in the *Associations Incorporation Reform Act 2012* (Vic).
- Reporting requirements by size of an association incorporated in NSW are set out in the *Associations Regulation 2016* (NSW).

Resources

Resources may range from funding as simple as club membership subscriptions to complex non-reciprocal funding from numerous sources. Many NFP entities will be supported by income comprising gifts, donations, grants, sponsorship, government funding, fundraising activities and/or volunteer services. Depending on the source of funding, the NFP may be required to provide financial statements, annual returns or funding/grant acquittals as part of the terms and conditions of funding.

1.4 NFP directors' duty of care

Responsible persons of NFPs may be called by different names such as director, committee member or office bearer. In substance, responsible persons are required to act in good faith for the benefit of the NFP and exercise due care and diligence in carrying out their duties in the NFP. The legislative requirements of the *Corporations Act 2001* (Cth) (Act) and case law in respect of directors' duties applicable to for-profit companies, are well established and are discussed further below. These requirements also apply to directors of companies limited by guarantee, as these companies are incorporated under the same Act. They are also indicative of the due care and diligence appropriate for responsible persons as defined in other legislation.

A director of a company is expected to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they held that same position of responsibility. This is the general duty of care and diligence as set out in the Act. Financial literacy is just one aspect of a director's duty with respect to the corporation.

Company directors are required to comply with statutory obligations set out in the Act and a lack of compliance could result in financial and other penalties. For instance, any director, regardless of the type of organisation and whether paid or voluntary, cannot delegate their responsibilities to sign off the company's statutory financial reports (which are prepared in accordance with Australian Accounting Standards) to other directors, company officers, financial experts or any party (financial information produced for external reporting is considered in **section 3.3**).

While directors' statutory obligations have not changed, there have been several court cases over the past two decades that have highlighted how vital financial literacy is and how severe the consequences can be when it is lacking. The *Centro* case of 2011[9] was important in reiterating directors' statutory responsibilities. While directors are entitled to delegate the preparation of the accounts and the day-to-day operations of the company to others, the directors have the specific responsibility under the Act to approve the financial statements. This responsibility cannot be delegated to management or the external auditors. Justice Middleton stated that each director is expected to "take a diligent and intelligent interest in the information available to him or her, to understand that information, and apply an enquiring mind to the responsibilities placed upon him or her".[10] Further, omissions in the relevant financial statements were not a "mere technical oversight" but "were matters that could have been seen as apparent without difficulty upon a focusing by each director, and upon a careful and diligent consideration of the financial statements"[11] and that in the circumstances, each of the directors should have enquired further into the matters revealed by the financial statements. Among several other aspects, the court dealt with a misclassification of significant borrowings as 'non-current' that should have been classified as 'current' in Centro's 2007 financial statements. Justice Middleton found each of the directors had essentially failed to take all reasonable steps to focus on the content of the financial statements and consider it for themselves, particularly the short-term debt.

In 2017, the Federal Court of Australia disqualified the managing director of Banksia Securities Ltd declaring he had contravened s 344(1) of the Act, in that financial reports for the company in 2011 and 2012 did not comply with accounting standards and did not give a true and fair view of the financial position or the financial performance of the company. Further, the managing director failed to have or to obtain a sufficient understanding of AASB 139 *Financial Instruments: Measurement and Recognition*, for the recognition and impairment of mortgage investments made by Banksia.

Currently, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne Royal Commission) has called into question the financial management and lack of adequate oversight by directors and senior executives of major financial institutions including the Commonwealth Bank of Australia (CBA) and AMP.

9 *ASIC v Healey* (2011) 278 ALR 618; [2011] FCA 717 (*Centro* case).
10 Ibid at [20].
11 Ibid at [23].

NFP directors will need to understand their duty of care obligations as set out in the relevant legislation and regulation and will need to understand financial information relevant to managing the NFP's activities.

1.5 Financial literacy

Financial literacy encompasses a combination of skills, background and experience. For NFP directors, financial literacy is largely about the ability to:

1. acquit formal legal and statutory obligations as they relate to financial matters, such as signing off on the annual financial reports;
2. monitor financial results to assess solvency and going concern;
3. balance risk mitigation (financial and otherwise) with the ability to drive their NFP's financial performance by understanding the 'story' told by its financial reports; and
4. know when financial experts are required to assist with the above points.

While these are the four pillars of financial literacy, other factors may shade the depth of financial skills and knowledge needed, such as their NFP's:

- operational model;
- operational plans and strategy;
- stage of growth;
- financial health;
- risk profile;
- skills mix around the boardroom table; and
- fit with the economy.

'Financial literacy' describes a basic understanding of the meaning attributed to the financial information of the NFP. The expected level of financial literacy of NFP directors is generally much higher than the level of financial literacy expected in the general population.

1.6 Financial literacy vs financial expert

An NFP board will comprise directors with various skills relevant to the NFP's purpose and activities. In addition, each NFP director should have an appropriate level of financial literacy, and the NFP board should have at least one NFP director, or an adviser, who is a financial expert. A financial expert can identify and action the most appropriate accounting treatment in a given set of circumstances. A financial reporting expert can choose and apply the correct accounting framework. Accounting frameworks explain *when*, *why*, *what* and *how* transactions should be described in accounting terms in a financial report. Several different accounting frameworks exist and the applicable accounting framework will not be the same in all circumstances (refer to **Chapter 5**).

However, the financially literate NFP director is not expected to have an in-depth knowledge of different accounting frameworks or the ability to action the required accounting treatment. Instead, a financially literate NFP director should be satisfied that the accounting framework required in the circumstances has been applied. He or she should also be able to understand *when* financial expertise is needed and *why* a particular course of action has been followed.

Financial reporting is a language used to explain business activities in financial terms. NFP directors should have an in-depth understanding of the NFP's activities and must have confidence 'the story' portrayed in financial terms in the NFP's financial statements is consistent with their understanding. The ability to read and understand this 'story' is at the heart of an NFP director's financial literacy.

Commitment to lifelong learning

The economic and social environment is dynamic and an NFP's activities are likely to expand and contract in response to changes in that environment. Changes in the economy and the business environment drive changes in financial reporting requirements and often, financial reporting changes are delivered in response to new developments. As the nature and scope of the NFP's activities evolve over time, the NFP's financial reporting requirements will also evolve.

For example:
An NFP starts life as a small group of volunteers providing meals for those in need (in effect, an unincorporated entity). As the activity becomes established, the group joins together to form an incorporated association so that the group can apply for grants and other funding in the name of the legal entity. As the number of supporters grow, the association seeks deductible gift recipient status from the ATO and registration with the ACNC. Each new stage in the life of the NFP is likely to introduce additional financial reporting obligations.

An NFP may remain at a stable level of operations, or may actively seek new opportunities. However, no strategy is risk-free and inevitably NFPs will take action to mitigate risk or simply agree to accept and monitor perceived risks with no immediate action taken. NFPs are unlikely to operate in isolation; they are likely to have supporters, beneficiaries, employees and communities that are impacted by their activities.

An NFP's strategies, activities, risk mitigation and relationships are captured and explained in the financial statements, both in the numbers reported and in the disclosure notes. As each of these factors evolve and change, the 'story' told in the financial statements will also evolve and change. NFP directors should remain alert to recognise the financial impact of change in their operating environment and changes in the size and nature of the NFP's operation. A commitment to lifelong learning is needed for directors to match financial reporting information with their knowledge of operational developments.

1.7 Financial governance

The AICD *Not-for-Profit Governance Principles* (*Principles*) state "good governance exists where an organisation has systems and processes in place that are appropriate to its circumstances and which enable the organisation to pursue its purpose effectively and meet its obligations under the law".[12] The *Principles* provide a practical framework

12 Australian Institute of Company Directors, 2019, *Not-for-Profit Governance Principles*, 2nd edition, January, p 11, http://aicd.companydirectors.com.au/-/media/cd2/resources/director-resources/not-for-profit-resources/nfp-principles/pdf/06911-4-adv-nfp-governance-principles-report-a4-v11.ashx, (accessed 27 February 2019).

to assist NFPs to understand and achieve good governance, including good financial governance.

In contrast to the *Principles*, the focus of this publication is to explain the fundamental financial practices and responsibilities that support good financial governance. For example, this publication considers the financial dimension of strategy, whereas the *Principles* consider how an NFP's strategy is derived from its purpose and then communicated and operationalised through the NFP's activities. In this sense, the *Principles* provide a complementary source of guidance for NFP directors, including good financial governance as a component of overall good governance.[13]

Financial governance, as an essential element of overall governance systems and processes, ensures the NFP meets its financial obligations to funders, supporters, government agencies and other stakeholders. Financial governance provides the link between the NFP's activities, carried out in accordance with its operational model, and reporting performance for both internal and external purposes. An understanding of financial performance provides NFP directors with an insight as to whether or not the NFP's operational model is capable of achieving the results anticipated. The primary areas of financial governance are:

- strategy;
- financing;
- reporting;
- monitoring; and
- solvency.

Financial governance also includes the NFP's responses to key issues and financial risks that arise at each stage of its lifecycle. It will also determine how financial decisions are made on a daily basis, ensuring there is an appropriate level of authorisation and oversight, depending on the extent of risk associated with the nature of the transaction.

13 The Australian Institute of Company Directors has a range of courses, including the *Company Directors Course*, which includes finance modules, specifically designed to improve financial skills for directors.

For example:
Routine transactions are likely to be approved by managers with appropriately delegated authority, whereas complex and unusual transactions would often require board approval.

Financial governance includes the response to reporting obligations, both internal and external, and the consideration of the critical financial issues and risks that are implicit in those processes. For NFP directors and boards, ensuring that "good decisions are made by the right person" includes identifying the expertise and capabilities required to carry out different financial roles within the NFP. Depending on its complexity, the financial skills and expertise needed by the NFP board and senior managers may range from basic bookkeeping to an in-depth knowledge of technical accounting requirements.

Financial governance includes oversight of:

- the employment of appropriately skilled persons;
- consultation with external professionals as needed;
- selection of external advisers with appropriate expertise and experience; and
- the continuing professional education of financial staff employed by the company.

In a small NFP without complex transactions, financial governance may involve establishing systems and processes to record transactions when they occur and monitor cash flows on a regular basis. Monitoring cash flows may be as simple as ensuring revenue is collected promptly and debts are paid as and when they fall due. In these circumstances, the NFP will require staff with basic bookkeeping skills only. Budgets and cash flow forecasts, together with periodic accounts, are likely to be prepared with the assistance of an external accountant. For a small NFP, these procedures may be adequate to satisfy financial governance obligations.

In contrast, financial governance practices will be significantly more extensive in a large NFP with more diverse activities and/or complex transactions.

To manage more diverse activities, a larger NFP will probably have a finance team led by a financial controller or chief financial officer. The NFP board of directors will need to have a good appreciation of the nature and extent of the NFP's transactions to ensure the financial governance practices in place are appropriate.

Strategy

An NFP will have a clear understanding of its purpose, as this is needed to support its status as a not-for-profit. In the absence of a not-for-profit status, the company will be deemed to be engaging in business, which then has tax implications. The NFP's strategy and operational model are used to document how the NFP plans to use its resources to achieve its purpose. Implementation of the NFP's strategy may incorporate the use of metrics, both financial and non-financial, which are then used to monitor performance and measure whether resources are being used effectively and efficiently. The NFP's strategy and operational model will need to incorporate consideration of any requirements set out by major funders and supporters.

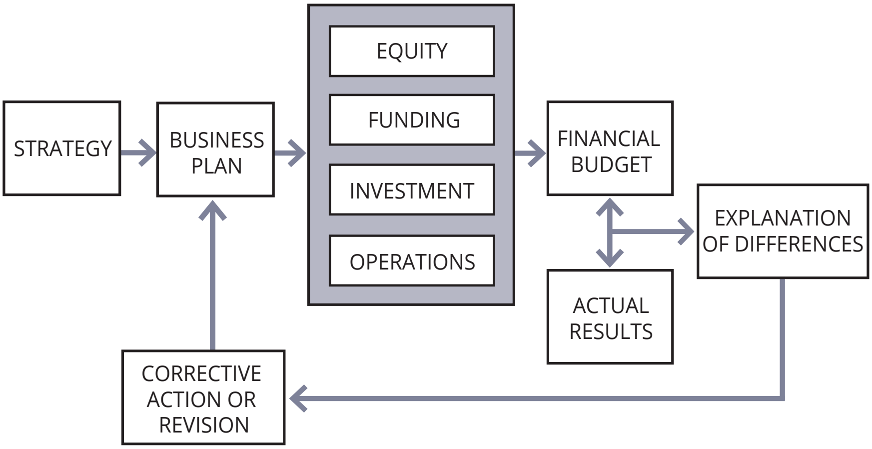
Different strategies will have differing financial impacts, which in turn, drive the NFP's financial governance practices. Financial literacy encompasses understanding the financial implications of strategy, including the associated risks. For example, the NFP's strategy and operational plan will include:

- major sources of funding;
- long and short-term funding;
- equity structure;
- cash flows; and
- impact of the accounting standards on the recognition and measurement of transactions.

The NFP's strategy and financial plans should be closely aligned with each other. The business plan, prepared to implement the company's strategy, will form the basis for the financial budget. Examination of the differences between actual results and the financial budget will provide insight into whether or not the business plan for the year can be achieved (internal reporting is considered further in **Chapter 3**).

Financial governance ensures the strategic plan includes an evaluation of the sources of funding available to the NFP to support implementation of its plan, assessment of the effectiveness of its investment decisions, and the extent to which additional funding may be required at each stage of strategy implementation.

Figure 1.1 NFP strategy and business plan



Financing

It is essential for NFP directors to consider how the NFP will be funded and the various funding sources available to support its activities.

For example:
When an NFP first starts operating, capital investment may be provided by donated assets. Incremental growth is likely to be achieved as the NFP identifies new sources of funds to support its activities, or through funds generated from operations.

As the NFP grows and new projects are introduced, other sources of funding may become available. Each year, the NFP directors will also decide whether a surplus is retained in the NFP to fund the risk of a shortfall in the future; or used for investments to generate income for the NFP's ongoing activities; or whether a surplus indicates that the level of activity can be increased. As the NFP's activities become more complex, good financial governance may require a formal financial management policy for investing decisions and evaluating operational opportunities.

Reporting

Most NFPs have both internal and external reporting obligations. All NFP's need internal reporting to monitor performance and to ensure that the NFP can pay its debts when they fall due. External reporting obligations vary with the size and nature of the company and its sources of finance.

Many NFPs will have obligations under their relevant reporting legislation to present and approve annual financial statements that are prepared in accordance with Australian Accounting Standards to present a 'true and fair' view of the company.[14] NFPs may be required to lodge their financial reports with the appropriate regulator such as Australian Securities and Investments Commission (ASIC), the ACNC, consumer affairs or the Australian Taxation Office (ATO). NFPs may be obliged to make their financial statements available to the public if they are held on public database such as the ASIC or ACNC databases, or they may choose to make them available to the public by presenting them on their website for funders and donors to access. NFP directors need to ensure they are aware of the extent of their regulatory responsibilities, together with the need to present information for funding applications, funding acquittals and in response to their members' and/or supporters' requests for information. NFPs may also have reporting obligations to the ATO and other government agencies.

All financial information presented for NFP board approval to meet reporting obligations should be robust and accurate, without material error. NFP directors will want to be satisfied the NFP has established appropriate accounting systems and internal controls (matters relating to internal controls over financial reporting processes are described in **section 6.3**). These processes may include, or require, external auditing of the financial information presented for NFP board approval.

Monitoring

Financial monitoring of the NFP's performance is a key responsibility of the NFP director. As such, information presented to the NFP board and management should facilitate this process and will include key performance indicators, cash flow forecasts and budgets. Monitoring cash flow is often critical in smaller NFPs or any NFP with funding constraints. If the NFP is required to achieve certain performance criteria

14 Public companies, large proprietary companies and small proprietary companies that are foreign-owned, have statutory reporting obligations under the *Corporations Act 2001* (Cth).

specified by major funders, the NFP board will also monitor these criteria to ensure that expectations are satisfied, in order to support continuing applications for funding. NFP directors will also need to ensure that record-keeping for different sources of funding is managed appropriately, to ensure that the financial information is reliable when funding acquittals are prepared.

Solvency

NFP directors have a responsibility to ensure the NFP is solvent and therefore able to pay its debts as and when they fall due. This means that NFP directors must be able to determine if there are reasonable grounds to believe the NFP can pay its debts. Insolvency is defined as the inability of the NFP to pay all of its debts as and when they become due and payable. There are significant penalties in the Act for directors of for-profit companies that trade while insolvent. For NFP directors, there may also be penalties under the relevant legislation if due care and diligence is not exercised in carrying out their duties.

For example:
State legislation for incorporated associations may include the same penalties for trading while insolvent as for-profit companies. For illustration, consider the *Incorporated Associations Reform Act 2012* (Vic), which states that certain provisions of the *Corporations Act 2001* are applied legislation. The civil penalties applying to office holders of an incorporated association in Victoria are referred to the provisions of the *Corporations Act 2001* as amended in the local legislation. Hence, a member of an NFP association in Victoria is liable for penalties up to $20,000 under the *Incorporated Associations Reform Act 2012* (Vic) if the association fails to pay its debts and becomes insolvent. Other actions at law to recover unpaid debts may also be taken against responsible persons who have been negligent or misleading in their actions.

In order to determine whether debts can be paid as and when they fall due, reliable, accurate and complete financial records must be maintained by the NFP. In Australia, a failure to keep appropriate records is a prima facie indicator of insolvent trading and can therefore have serious consequences for NFP directors, who will be deemed, prima facie, to have permitted the NFP to trade while insolvent. The nature and extent of activity in the NFP determines the nature and extent of accounting records that need to be maintained to demonstrate that the NFP's accounting records are adequate (for a more detailed discussion about insolvency and its link to the accounting concept of 'going concern' refer to **section 4.3**). In addition, when cash and bank balances are at minimal levels, a cash flow projection is essential to ensure that cash deficiencies can be identified ahead of time and mitigating action taken so that debts can be paid when they fall due.

1.8 Summary

NFPs vary in their purpose, legal structure and size. Their reporting obligations are set out in the legislation under which they are established, and their resources and social impact may be closely correlated with support from their stakeholder. NFP directors have a duty of care, similar to the duty of care expected from for-profit directors, to ensure they have a level of financial literacy commensurate with the size and nature of the NFP's activities. These obligations are set out in legislation and illustrated by numerous examples in recent case law.

Financial literacy is needed to implement financial governance practices that are appropriate for the business model in place. NFP directors need to be concerned with monitoring their NFP's performance to demonstrate they have reasonable grounds to believe their NFP can pay its debts when they fall due. NFP performance is explained in both internal and external financial reports.