Literature-informed definitions employed to define the scope and nature of small not-for-profit organisations in Australia

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Abstract

A Productivity Commission report released in 2010 indicated that the not-for-profit (NFP) sector contributed $43 billion to Australia's GDP in 2006-07. Of the 600 000 NFPs, only 58 779 have an active tax role while the majority are small unincorporated organizations.

Although there are many studies focussing on large and small companies and large NFP organisations, there is not much literature focussing on small NFPs. The four business structures above differ in their reporting requirements, make up and organisational structure. There is a distinct gap in literature for small NFP organisations.

The Term NFP is somewhat misleading as it implies that the organisation does not make a profit. In practice, NFPs do make profits but the profits are not distributed to its members but channelled back into the organisation as surplus. This paper presents literature-informed definitions for NFP organisations employed to define the scope and nature of the organisations under study.

This paper is the first part of a larger research with the final objective of proposing a model code of conduct for Directors and Officers of small NFP. Steps that will be taken to reach the above outcome is to review literature in the area, propose a model of best practice, carry out a survey of NFPs using a questionnaire and finally design a model code of conduct by analysing the data. The larger study will consider a sample size of 300 small NFP organisations in NSW based on the NSW Department of Fair Trading Tier 2 organisations.

Introduction

This article is the first of a series of papers emerging from a doctoral study of small not-for-profit (NFP) organisations in Australia. The purpose of this doctoral study is to propose best practice and a model code of conduct specifically for Directors and Officers working in small NFPs in Australia.

Much has already been written about financial controls and governance mechanisms for large and small companies and for large NFP organisations. To date, there has been little research focusing on small NFP organisations. This particular section of the sector operates differently and faces different challenges than large NFPs.

This paper presents literature-informed definitions for NFP organisations employed to define the scope and nature of the organisations under study. Further, the operation and contributions of NFPs in Australia will be explored. These meanings, operations and contributions describe the context for the research.

Subsequent papers will concentrate on financial controls, governance mechanisms and reforms in this section of the NFP sector in Australia.

Not-for-profit

NFP organizations go by different names such as 'non-profit' organizations or 'the third sector' (Lyons & Passey, 2006). The first sector is the public sector or the government sector. The second sector is the private sector which is the commercial sector. The term 'the third sector' is designated to the NFP sector (Lyons & Passey, 2006; Australian and New Zealand Third Sector Research Incorporated, 2011).

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The term 'not-for-profit' is somewhat misleading as it implies that the organisation does not make a profit. A NFP organisation can make profits but the profits are not distributed to its members (Lyons & Passey, 2006; Hansmann, 1996; E.L. Glaeser, 2003; Twaits, 1998; Productivity Commission, 2010; Australian Taxation Office, 2011a). Instead, they are channelled back into the organisation as surplus and must be used to carry out the organisation's purpose (Australian Taxation Office, 2007).

The NFP sector is made up of organizations aimed at creating social value for society as a whole and do not create profit for stockholders (Emanuele Lettieri, 2004).

A not-for-profit organisation can distribute its profits by improving the working environment of the staff and volunteers which can come in the form of free meals, attractive benefits and longer leave (E. L. S. Glaeser, A, 2001). In a research conducted by Glaeser & Shleifer in 2001, they concluded that they expect to find higher levels of benefits available in not-for-profit than for-profit firms in the form of better working conditions, higher wages and other benefits for the employees (E. L. S. Glaeser, A, 2001).

The definitions derived from Australian and international sources identify elements of the meaning of NFP organisations. The first is the Australian Government's main revenue collector which is the Australian Taxation Office. The second is the Productivity Commission which is the Australian Government's independent research and advisory body (Australia Government, 2012) and the other three definitions are academic sources.

According to the Australian Taxation Office (2011), the acceptable NFP definition is

> '*The assets and income of the organisation shall be applied solely in furtherance of its above-mentioned objects and no portion shall be distributed directly or indirectly to the members of the organisation except as bona fide compensation for services rendered or expenses incurred on behalf of the organisation*' (Australian Taxation Office, 2011).

According to the Productivity Commission (2010),

> *'An NFP organisation is an entity that imposes the non distribution of profits to the members of the organisation' (Productivity Commission, 2010)*

According to Twaits (1998),

> *'...those operating in the non-profit sector are typically prohibited by statute and/or their constituent documents from distributing any profits they do make to their members.'* (Twaits,1998).

According to Hannsman (1996),

> '...the critical characteristic of a nonprofit firm is that it is barred from distributing any profits it earns to persons who exercise control over the firm.' (Hansmann, 1996).

According to Glaeser (2003),

> 'Nonprofit organizations have tax privileges...cannot disburse profits to owners...do not have owners.' (E. L. Glaeser, 2003)

What is evident from all the definitions above is that a NFP organization is not allowed to distribute its profits to its members. This condition applies to the organization in the duration of its life and when it winds up (Australian Taxation Office, 2007).

The purpose of an NFP is to provide a service to society. NFPs have a range of different purposes, come in a variety of shapes, sizes and locations, and take different approaches to production and management (Productivity Commission, 2010). They operate in a number of different market sectors which are economically active such as sports and education, as well as in social or community 'non-economic' activities such as civil rights and religion (Productivity Commission, 2010).

The Productivity Commission was commissioned to assess the contribution of the NFP sector and the obstacles to its development due to the sector's broad achievements and diversity (Productivity Commission, 2010).This commission researches and gives the government advice on a range of economic, social and environmental issues affecting the welfare of Australians (Australia Government, 2012).

According to the Productivity Commission (2010), there are approximately 600 000 NFPs in Australia excluding body corporate such as for strata titles. About 440 000 are believed to be small unincorporated organisations and 58 779 NFPs are classified by the Australian Bureau of Statistics as 'having an active tax role' for employing staff or accessing tax concessions (Productivity Commission, 2010). The 58,779 NFPs are considered to be 'economically significant' employing 889 900 staff, making up around 8 per cent of employment, and contributing under $43 billion to Australia's GDP in 2006-07 (Productivity Commission, 2010).

The Gross Domestic Product (GDP) increased from 3.3 to 4.1 per cent of GDP between 1999-2000 and 2006-07, reflecting strong average annual growth of 7.7 per cent in the NFP sector over the same period (Productivity Commission, 2010).

The executive management of an NFP can take the form of a single Chief Executive Officer (CEO) in a small organization or a multi-layered management team in a larger organization. In any case there is a person or a team that is accountable for the financial management of the organization.

In a small NFP, the CEO is expected to be skilled in the management of finances, human resources, facilities and assets while at the same time to be an expert in their field. This is not always possible and very often the financial management aspect of the organization undergoes difficulties.

Before the legal structures and financial requirements of NFP organizations are researched, it is important to first learn about when, why and how they were established in Australia.

A brief history of NFP organizations

The NFP organisation is not a new establishment in Australia. It first began in Australia about two hundred years ago.

The Benevolent Society was established in 1813 and is believed to be the first NFP organisation in Australia (Great Southern Press, 2009). It has actively promoted change at the cause of social issues, established the Sydney Leadership Program as pioneers in developing social leadership for social change (Great Southern Press, 2009).

YWCA which began in Great Britain in 1855 was established in Sydney in 1880, making it the second oldest NFP in Australia. It was established by Lady Kinnaird and

Miss Emma Roberts to create a safe place for homeless women and girls. The Sydney branch was established by Mary Jane Barker, the wife of the then Sydney Bishop Frederick Barker. There are 132 YWCA in the world today which continue to value its commitment to the social, economic and political equality of women (YWCA NSW).

The Royal District Nursing Service was established in 1885 and has since been delivering home nursing care. The nursing care now includes a wide range of general and specialist nursing services (Royal District Nursing Service, 2011).

In 1889, five Sisters of Charity came to Melbourne with the hope of setting up a hospital and their vision was realised on 6 November 1893 when they established a small 'cottage hospital' with about 30 beds. They treated 2584 patients including 441 as inpatients in the organisation's first fourteen months. Some of the not-for-profit's key achievements are the building of the hospital's first all-purpose built wing and the establishment of the St Vincent's Clinical School (St. Vincent's, 2011).

Internationally, many well-known entrepreneurs have been historically involved in NFP organizations. In 1964, Jean-Henri Dunant started the Red Cross in Geneva after witnessing the battle of Solferino (E. L. S. Glaeser, A, 2001). Dunant co-founded another significant non-profit, the World's Young Men's Christian Association and won the first Nobel Peace Prize in 1901 (E. L. S. Glaeser, A, 2001).

In recent years, world renown entrepreneur Bill Gates along with his wife Melinda founded the Bill & Melinda Gates Foundation in Seattle to help all people lead healthy, productive lives (Bill and Melinda Gates Foundation, 1999). In the United States, the foundation aims to ensure that everyone has access to the opportunities they need to succeed in school and life and in developing countries, the focus is in improving people's health (Bill and Melinda Gates Foundation, 1999).

Having a charitable constitution, the NFP set up looked very attractive to the Australian and International people and carved a permanent role in their societies.

Legal structures of not-for-profit organisations

Over the years, NFP organizations have grown and the government has allowed NFP organisations to take the form of one of the three legal structures below:

- public company limited by guarantee (governed by the Corporations Act).
- incorporated association (governed by state Associations Incorporation Acts).
- unincorporated association (Australian Institute of Company Directors, 2007), (Twaits, 1998).

Under a company structure, a NFP organization is registered as a public company that is limited by guarantee. In the Corporations Law, Section 9, the company limited by guarantee is defined as one that is formed on the basis of having the potential liability of members limited to the amount that a particular member has 'guaranteed' to pay under the company's memorandum of association (Twaits, 1998). The term 'limited by guarantee' indicates that the liability of the company's members is limited to the amount the members undertake to contribute to the property of the company should it wind down (Australian Securities and Investments Commission, 2010a; Australian Institute of Company Directors, 2007).

In the event of a winding down of an NFP organisation which is registered under the Corporations Law, Section 517 provides that members of a company limited by guarantee will not be required to contribute more than the amount they have guaranteed under the constitution (Twaits, 1998). If however, a company has insufficient funds to meet its liabilities, persons who were members within a year of the date on which the winding up action commenced may be required by the courts to honour their guarantees under Pt 5.6 Div 2 of the Corporations Law (Twaits, 1998). Past members are liable to debts incurred only up to the date on which they ceased to become members of the company.

By taking the step to register a company, the members create a legal entity separate from its members, enabling the company to hold property and sue and be sued (Australian Securities and Investments Commission, 2010a). The Corporations Act 2001 under which companies are registered is Commonwealth legislation administered by the Australian Securities and Investments Commission (Australian Securities and Investments Commission, 2010a). This registration is recognized Australia wide.

Any reference to shareholders in the Corporations Law does not apply to members of companies limited by guarantee because such companies do not have a share capital. A reference to a 'member' includes a reference to a member of a company that is a company limited by guarantee apart from specific exceptions (Twaits, 1998).

The second way in which an NFP organization can be registered is as an association. Associations are incorporated under State and Territory Associations Incorporation legislation regulated by the different state authorities and are not administered by the Australian Securities and Investments Commission (Australian Securities and Investments Commission, 2010a). Members are immune from personal liability at the suit of third parties in their capacity as members (Twaits, 1998).

Incorporating an association in a State or Territory restricts the organisation to operating only in the state or territory in which it is registered (Australian Securities and Investments Commission, 2010a).

In Australia, the term 'unincorporated association' is usually applied in relation to a group of people who meet for a common interest and serve in a voluntary capacity to further a common interest or purpose (Twaits, 1998). Although their members' subscriptions are their main form of funding, they also raise funds through intermittent fundraising activities such as raffles, etc). A committee elected by the members manage and run the organisation (Twaits, 1998). Some unincorporated associations have a constitution or a statement of objectives but others do not (Twaits, 1998).

In an unincorporated association, there is no relationship between members and the association, whether contractual or otherwise. The lack of a contractual relationship between the members and the association means that members had no standing to challenge the decisions of the association's committee (Twaits, 1998). Although the above legal structures are available for registering NFP organisations of all sizes, the focus of this paper is only small-to-medium sized NFP organisations in Australia.

Business structures

This section of the sector occupies one quarter of the business pie. The four types of business set-up are large and small companies, and large and small NFP organisations. It is important to first investigate what makes up each of the structures.

There are many differences amongst the four structures such as their reporting requirements, their size and who runs each of them. The requirements for small organisations, whether they are companies or NFPs, are less stringent. The first table below spells out their definitions.

Table 1: Four business structures

Large proprietary companies Satisfy at least two criterion: ➢ combined income is ≥ \$25 m ➢ gross assets is ≥ \$12.5 m ➢ ≥ 50 employees (Australian Securities and Investment Commission 2010c).	**Small proprietary companies** Satisfy at least two criterion: ➢ combined income is < \$25 m ➢ gross assets is < \$12.5 m ➢ < 50 employees (Australian Securities and Investment Commission 2010c).
Large NFP organizations in NSW (Tier 1) ➢ gross receipts exceeding \$250,000 or ➢ current assets exceeding \$500,000 (Department of Fair Trading 2010).	**Small NFP organizations in NSW (Tier 2)** ➢ gross receipts under \$250,000 (Department of Fair Trading 2010).

Table two below illustrates what their reporting requirements are. In NSW, the Department of Fair Trading has specific financial reporting regulations based on the Associations Incorporation Act 2009 which divides associations into two categories for reporting purposes. From the 1st July 2010, associations with gross receipts exceeding \$250,000 or with current assets exceeding \$500,000 are referred to as Tier 1 associations and they are required to submit audited financial statements each year to their members at the AGM (Department of Fair Trading, 2010). For the purpose of this research, we will consider Tier 1 associations as being large NFP organisations.

Smaller organisations which are referred to as Tier 2 associations with gross receipts under \$250,000 are only required to submit a summary of their financial affairs at the AGM (Department of Fair Trading, 2010).

Table 2: Financial requirements for the four business structures

<table>
<tr><td>Large proprietary companies
Required to submit
➢ a financial report
➢ a directors' report
➢ accounts be audited (unless relief granted)
(Australian Securities and Investment Commission 2010c).</td><td>Small proprietary companies
Required to submit
➢ Some companies required to lodge financial reports
(Australian Securities and Investment Commission 2010c).</td></tr>
<tr><td>Large NFP organizations in NSW (Tier 1)
Required to submit:
➢ audited financial statements at AGM
➢ audited financial statements to the Department of Fair Trading
(Department of Fair Trading 2010).</td><td>Small NFP organizations in NSW (Tier 2)
Required to submit:
➢ a summary of their financial affairs at the AGM
➢ a summary of their financial affairs to the Department of Fair Trading
(Department of Fair Trading 2010).</td></tr>
</table>

Another important difference amongst the four structures is the issue of who runs the organizations. In a large company, there is a clear separation of ownership and control. The company is owned by its shareholders or partners. It is controlled by the Board of Directors and or the CEO. This is not the case in a small company because the owner runs the company and controls it. There is no separation of ownership and control.

In an NFP organization, whether it is large or small, control and ownership is similar to a large company because there is a clear separation of ownership and control. The members are the owners while the organization is controlled by a CEO and the Board of Directors.

Table 3: Ownership and control of the four business structures

<table>
<tr><td>Large proprietary companies
➢ Separation of ownership and control</td><td>Small proprietary companies
➢ No separation of ownership and control</td></tr>
<tr><td>Large NFP organizations in NSW (Tier 1)
➢ Separation of ownership and control</td><td>Small NFP organizations in NSW (Tier 2)
➢ Separation of ownership and control</td></tr>
</table>

There is a perceived expectation that the person or people who control the organisation will act in the best interest of the owners. In reality, this is not always the case, hence there is a need for financial controls, governance mechanisms, code of conduct and best practice models to ensure that the people who control an organisation act in the best interest of its owners and not in their own personal interests.

For the purpose of this research, a small to medium-sized NFP organisation is defined to be a Tier 2 NFP organisation with a gross receipt of under $250,000. The researcher will not be considering body corporate such as for strata titles and small unincorporated organisations. This research will only cover NFPs that are considered by the Australian Bureau of Statistics to have an active tax role and that employ staff or access tax concessions.

Management styles in not-for-profit organisations

All levels of manager have different management styles. A predictive financial manager uses his or her analytical skills to plan and develop strategic directions. This manager will regularly compare actual results with budgetary figures (Reh, 2010). Problems are anticipated and opportunities are taken advantage of.

This style of financial management brings to management's attention weaknesses before they reach crisis proportion and allows the manager to implement processes to reduce the effects of the problem or eliminate the problem altogether (Reh, 2010). Predictive managers make decisions that bring about the necessary adjustments before major problems develop so that fewer resources are spent on reacting to problems that arise (Reh, 2010).

Another type of financial manager goes from crisis to crisis with little time in between to notice opportunities that may become available (Reh, 2010). Instead of planning ahead and anticipating problems, the manager waits for problems to crop up and then reacts by crisis management to solve them. This is the reactive manager who is seldom prepared to take advantage of new opportunities quickly (Reh, 2010).

The best type of financial manager is one who anticipates problems and is prepared to solve them if they emerge. However, in the absence of large resources and several layers of support staff, it is necessary to have effective internal controls and governance mechanisms. This is especially critical for an underfunded small to medium sized not-for-profit organization that only has a CEO who performs many functions to ensure the organisation's financial interests are safeguarded.

Effective internal controls and governance mechanisms also help the management or the governing body of an NFP entity to meet its fiduciary responsibility. Fiduciary responsibility of an NFP will be explained further in a subsequent paper.

Strategic management sets the long-term direction of an organization (Martello, Watson, & Fischer, 2008). It is a set of measures that an organisation's executives and directors devise to ensure long-term progress. Effective internal controls and governance mechanisms are part of strategic management. It also includes industry analysis, setting strategic objectives and strategic options, implementation of strategies and evaluation and control (Wheelen & Hunger, 2008).

Managers may manage the changing world environment by progressing through four phases of strategic management (Gluck, Kaufman, & Walleck, 1982). According to Gluck, Kaufman and Walleck (1982), phase 1 entails fundamental financial planning. This planning takes place at the time of the preparation of the following year's budget (Gluck, et al., 1982).

Gluck, Kaufman and Walleck (1982) go on to state that phase II involves a longer term financial planning such as a five- year plan. It requires senior management and the directors to forecast future growth.

Phase III consists of externally oriented planning caused by the political environment and changes in trends (Gluck, et al., 1982). Lastly, phase IV involves top management to form planning groups at different levels and across departments for input and commitment from lower level managers to ensure the success of the strategic direction (Gluck, et al., 1982).

There are many challenges for all management including the management of small-to-medium size NFP organisation such as the impact of globalization, electronic commerce, diversification of the workforce, rapid technological advances, governmental regulations, and increasing competitive forces in the environment (Wheelan and Hunger 2008).

A small, under-resourced NFP organisation would find it very challenging to keep up with the progress of its for-profit counterpart and maintain a high level of accountability that is expected of a NFP organisation.

Accountability of not-for-profit organisations

There have been growing calls for accountability and major donors increasingly want evidence of the effectiveness of the activities, and prefer NFPs that can provide robust business cases for the investments they seek (Steane & Christie, 2001; Productivity Commission, 2010). Although most NFPs concur that significant financial contributions warrant accountability such as audited accounts and business plans and demonstrable results, it is also felt that current requirements are not appropriate, impose compliance costs without commensurate benefits and are lacking any sense of proportion in regard to the size of the organisation or scale of the undertaking (Productivity Commission, 2010).

The reporting requirements have not been standardised. They differ from department to department, differ between state and federal bodies and are in some cases too complex and difficult to understand. The current regulatory framework for the sector is considered to be complex, lacks coherence, lacks sufficient transparency, and is costly to NFPs (Lyons& Passey, 2006; Productivity Commission, 2010).

The Commission (2010) recommended the setting up of a nationwide single department for Commonwealth regulation in the form of a Registrar for Community and Charitable Purpose Organisations to improve and consolidate regulatory oversight and enhance accountability to the public. A statutory organ within the Australian Securities and Investments Commission could initially be established to ensure timely implementation and administrative efficiency (Productivity Commission, 2010). This new statutory body would also replace the equivalent functions in existing regulators.

Conclusion

The duties and liabilities for directors in different types of companies whether it is FP or NFP organisations are generally similar. There may however, be some differences between state legislation and the Corporations Act.

Whatever form of legal structure an NFP organisation may take, all actions must be carried out in good faith and in the best interests of the organisation (Australian Institute of Company Directors, 2007). For that reason, registered NFP organisations are required to be financially accountable.

By identifying strong financial controls and introducing good governance mechanism, best practice for small-to-medium sized NFP organisations can be determined and a model code of conduct can be developed. This may help the 90%

NFP organisations that are not economically significant to increase productivity and may even help reduce the number of NFPs that become insolvent.

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