

[DRAFT] Briefing Paper

**Financial Reporting by Small Proprietary Companies using
Crowd-sourced Equity Funding (CSEF)**

August 2015

CSEF Proposals for Small Proprietary Companies

The Australian Accounting Standards Board (AASB) notes the Australian Government's proposals set out in the Consultation Paper (CP) "Facilitating Crowd-sourced Equity Funding and Reducing Compliance Costs for Small Businesses" (August 2015).

In particular, the AASB notes paragraph 72 of the CP, which states:

To address concerns that small CSEF investors may lack ongoing access to information about the company and its performance, additional transparency obligations similar to those applying under the public company CSEF regime could be placed on proprietary companies using CSEF, including:

- a requirement for financial and directors' reports to be prepared and made available to shareholders online; and/or
- a requirement to appoint an auditor and have financial statements audited once the company has reached certain thresholds, such as raising \$1 million from CSEF or from other offers that do not need disclosure under Chapter 6D of the Corporations Act.

The AASB considers that it is important for adequate financial information to be available to CSEF investors and supports the suggestion that the current financial reporting requirements outlined in paragraph 70 of the CP for small proprietary companies should be augmented by additional transparency obligations if they use CSEF.

Financial Reporting by Small Proprietary Companies using CSEF

Paragraph 72 of the CP refers to a potential requirement for financial reports to be prepared by small proprietary companies using CSEF and made available to shareholders online. Since the AASB sets Australian Accounting Standards that apply under the *Corporations Act 2001* to company financial reports, the AASB is interested in ensuring that the financial reports are of a suitable quality for their intended purpose.

Australian Accounting Standards apply in general to what are called 'reporting entities' and to financial reports that are, or are held out to be, 'general purpose financial reports'. As defined in AASB 1053 *Application of Tiers of Australian Accounting Standards*, general purpose financial reports are financial reports intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs. Reporting entities are entities in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial reports for information that will be useful to them for making and evaluating decisions about the allocation of resources.

Based on these definitions, the AASB considers that small proprietary companies using CSEF would be reporting entities, and their financial reports should be general purpose financial reports.

This conclusion is consistent with comments in various parts of the CP. For example, paragraph 53 notes the wide range of potential investors under CSEF and that many resulting shareholders may not have any other connection to a company and consequently little access to ongoing information about its performance or ability to influence its affairs. Paragraph 68 goes on to address reasonable transparency obligations that would go with ensuring that new shareholders have access to a similar amount of information to shareholders in public companies using CSEF.

Accordingly, the AASB takes the view that it would be appropriate for the CSEF framework to require small proprietary companies using CSEF to prepare general purpose financial reports explicitly, rather than merely referring to financial reports.

General Purpose Financial Reports

Accounting Standard AASB 1053 provides a differential reporting framework consisting of two tiers of reporting requirements for preparing general purpose financial statements. Tier 1 requirements incorporate International Financial Reporting Standards (IFRSs), including Interpretations. Tier 2 requirements comprise the recognition and measurement requirements of Tier 1 but substantially reduced disclosure requirements in comparison with Tier 1.

Tier 1 requirements are mandatory for for-profit private sector entities that have ‘public accountability’. This term is defined in AASB 1053 as accountability to those existing and potential resource providers and others external to the entity who make economic decisions but are not in a position to demand reports tailored to meet their particular information needs. A for-profit private sector entity is then described as having public accountability if either of two circumstances apply.¹ The first circumstance is relevant here.² In this case, the entity’s debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market. A public market includes a domestic or foreign stock exchange and over-the-counter markets.

This is relevant to small proprietary companies using CSEF if shareholders have access to public markets of some form for trading their CSEF investments. If so, then Accounting Standards presently would require such companies to present general purpose financial reports that comply with Tier 1 requirements – provided that the Corporations Act first required them to prepare financial reports (or, more specifically, general purpose financial reports).

If the definition of public accountability is not satisfied, then a small proprietary company using CSEF should be required at least to prepare general purpose financial reports that comply with Tier 2 requirements. This would require the Corporations Act to specify that such companies are required to prepare general purpose financial reports, rather than merely requiring financial reports.

The reason for specifying the requirement in this way is that large and small proprietary companies preparing financial reports under Corporations Act requirements may in some

1 The description is drawn from the *International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)*, issued by the International Accounting Standards Board.

2 The second circumstance is that the entity holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses, such as financial institutions and securities brokers/dealers. Some types of for-profit entities are also deemed to have public accountability, such as disclosing entities and registered managed investment schemes.

circumstances prepare what are called ‘special purpose financial reports’, rather than general purpose financial reports.

Special Purpose Financial Reports

Special purpose financial reports are intended to comply with Australian Accounting Standards except for very limited disclosure requirements, as set out in ASIC Regulatory Guide 85 *Reporting Requirements for Non-reporting Entities*. However, there is wide variation in the application of Australian Accounting Standards in special purpose financial reports lodged with ASIC by companies, and the absence of explicit evidence of compliance with the Standards has the potential to reduce the reliance that users can place on the financial statements.³

A company may decide to prepare special purpose financial reports rather than general purpose financial reports if those governing the entity conclude that it is not a reporting entity. In this case, only a few of the Australian Accounting Standards would apply directly to the entity, and the ASIC Guide then sets out ASIC’s expectations for compliance with the Standards.

Consequently, the AASB considers that small proprietary companies using CSEF should not be permitted to prepare special purpose financial reports to satisfy Corporations Act transparency obligations. Thus, the Corporations Act should require such companies to prepare general purpose financial reports.

Alternatively, the AASB potentially could amend AASB 1053 to deem such companies as having public accountability (which means that they would be required to comply with Tier 1 requirements) or to deem them to be reporting entities (which would require compliance with at least Tier 2 requirements). However, this would be inconsistent with the AASB’s future direction which is to establish the various tiers of reporting requirements, in order to permit other regulators to determine the level of financial reporting required of regulated entities.

Public Lodgement of Financial Reports

The Consultation Paper refers to the prospect of requiring small proprietary companies using CSEF to prepare financial reports that are made available to shareholders online, with requirements for hard copy reports where a shareholder requests such after five years (paragraphs 72 to 74). The AASB notes that these suggestions do not refer to public lodgement of the financial reports. This should be clarified in developing the CSEF proposals further for small proprietary companies.

As the adoption of CSEF would represent a substantial departure from the concept of proprietary companies as small and closely held companies (CP paragraph 54), public lodgement of financial reports would be consistent with extending large proprietary company transparency obligations to small proprietary companies using CSEF.

3 AASB Research Report No. 1, *Application of the Reporting Entity Concept and Lodgement of Special Purpose Financial Statements* (June 2014), Executive Summary, paragraph 20.