Crowdfunding: Issues Pertaining to Financial Reporting and Assurance in Malaysia

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ABSTRACT

Crowdfunding is used as a platform to fund new business enterprises and is also a good platform to gather funds for non-profit projects. With the advent of alternative funding, issues pertaining to financial reporting and assurance have become issues that are relevant to investor relations of the new forms of funding. Traditional funding has been long subjected to various legislatures that require the unit to comply with the various financial reporting requirements of the various regulators in the country. There is a need for the regulation of crowdfunding and the various forms of alternative funding for the protection of the backers of such schemes. The current legislation that is related to crowdfunding and alternative funding was reviewed and matched against current requirements of financial reporting and assurance of traditional forms of business such as listed companies. It was found that ownership rules, financial reporting regulations and governance are minimal and there is a need for tighter regulations to govern this form of funding here in Malaysia and internationally.

Keywords: Audit and Assurance, Accounting Standards, Crowdfunding, Corporate Governance

INTRODUCTION

Throughout history, mankind has created various forms of platforms for funding – legal or illegal, big or small, regulated or unregulated. Even though traditional forms of finance such as banks and capital markets are still a popular form for entrepreneurs and charities to source funding, the internet has opened up new funding avenues for them. Crowdfunding is used as a platform to fund new business enterprises and also as a platform to gather funds for non-profit projects. With the advent of alternative funding, issues pertaining to financial reporting and assurance have become issues that are relevant to investor relations of the new forms of funding.

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Crowdfunding is a form of funding whereby many small amounts of money are raised from a large number of people to finance a project or venture. Crowdfunding has been used to fund a wide range of for-profit entrepreneurial ventures and also non-profit ventures such as community-oriented social entrepreneurship projects. One example of one successful crowdfunding project is the Grammy Award winning "Voyager Golden Record" project in 2017. The public was asked to pledge between US$10 to US$490 on Kickstarter. Kickstarter is an American public-benefit corporation that maintains a global crowdfunding platform focusing on creative arts such as films, music, stage shows, comics, journalism, video games, technology and food-related projects. As at 28 January 2018, the day the project won the "Best Boxed or Special Limited Edition Package" Grammy, over US$1.3 million had been raised from their backers. Peer–to-peer (P2P) financing is a web-based application that allows entrepreneurs and small business owners to raise capital from a pool of individual investors in small amounts and provides a quick turnaround time to obtain financing for their businesses, through an online digital platform.

There are currently two forms of crowdfunding. The first is equity crowdfunding (ECF) and the other is non-equity crowdfunding. The website Investopedia defines "investment crowdfunding" (or equity crowdfunding) as "a way to source money for a company by asking a large number of backers to each invest a relatively small amount with it. In return, backers receive equity shares of the company." The definition further says "backers receive equity shares of the company". The legality of the above quotation will be discussed later in this paper. There is no official terminology to date for crowdfunding for non investment purposes. In this paper the second form of crowdfunding will be referred to as "non-equity crowdfunding".

Financial Reporting for Traditional Funding

Traditional funding has been subjected to various legislatures that require the unit to comply with the various financial reporting requirements of the various regulators in the country. The Companies Act 2016, the Societies Act 1966, the Partnership Act 1961, the Limited Liability Partnerships Act 2012 and the Companies Commission of Malaysia (CCM) Act 2001 regulate the establishment of businesses and societies in Malaysia while Bursa Listing Requirements and the Malaysian Code of Corporate Governance regulate the conduct of listed entities on Bursa Malaysia. Bank Negara Malaysia regulates financial institutions in the country. Issues pertaining to the reporting and disclosure of financial information, auditing and governance are laid out clearly in the aforesaid regulations. The Malaysian Accounting Standards Board (MASB) established under the Financial Reporting Act

1997 (the Act) acts as an independent authority to develop and issue accounting and financial reporting standards in Malaysia. The MASB determines how accounting issues are addressed and how financial results are published and reported.

The Case for Financial Reporting for Equity Crowdfunding in Malaysia

Malaysia introduced a regulatory framework to facilitate equity crowdfunding in 2015 and another for P2P financing in 2016. At the time of writing, there are minimal rules and regulations on financial reporting for alternative funding i.e. non-equity crowdfunding, ECF and P2P financing in Malaysia. Most of the regulations pertaining to alternative funding lie in the Guidelines on Recognized Markets issued by the Securities Commission of Malaysia (SC) in 2015 and revised in 2016.

The Guidelines on Recognized Markets focuses mostly on the financial reporting aspects of the set-up of the Recognized Market Operator (RMO) and reporting to SC. Paragraph 1.03 of the Guidelines makes it clear that all RMOs must be a body corporate or a limited liability partnership (LLP). This brings all RMOs to be either under the Companies Act 2016 or the Limited Liability Partnerships Act 2012. Unlike practices overseas, societies or non-profit organisations per se, like many promoted on Kickstart, are not permitted to become RMOs. The only way non-profit organisations can become RMOs is for those organisations to be registered either as companies or as LLPs.

Paragraph 7.01 requires all RMOs to submit their latest audited financial statements within three months after the close of each financial year to the SC and similar filings must be made at the CCM as required by the Companies Act 2016 or the Limited Liability Partnerships Act 2012. However, since the RMOs are not public companies, the audited financial statements of the RMOs are not published to the public.

Current listing requirements require public listed companies to publish regular reports (as regular as quarterly) to their shareholders so that shareholders are made aware of the financial performance of their investment. Regulators require unit trust companies to publish their results to their trust holders. ECF works in a way similar to unit trusts. Unit holders provide small amounts of funds to unit trust companies to invest in various companies or businesses, while crowdfunding collects small amounts of capital from many backers. RMOs are not subject to such rigorous reporting requirements unlike unit trust companies. RMOs are not obliged to publish their financial results to their backers since the backers are in the legal sense not shareholders of the business. Backers would have to go to the CCM to purchase a copy of the audited accounts if they want information about the financial results of their RMO.

Is the financial information available at the CCM useful for the backers for decision making – if they decide to spend money to retrieve the information? It is not thought so. The Companies Act 2016 requires an RMO file the financial report of the whole enterprise and not different projects crowdfunded in that particular RMO.

There are gaps in company law pertaining to the ownership of an ECF. The Guidelines on Recognised Markets make it a requirement that information on the promoters of the ECF must be provided to SC during the process of registration. A similar procedure is applied to traditional companies when those companies plan to place an Initial Public Offer (IPO) on Bursa Malaysia.

However there is not much clarity regarding the ownership of an ECF. Are backers shareholders of the ECF? Investopedia mentions that “backers receive equity shares of the company”. The Companies Act 2016 is silent on this. In traditional companies including those over-the-counter or private companies, successful applicants to a new company are allotted shares by the promoters and upon the payment of the allotted share capital, the applicant will become a shareholder. Shareholders are then owners of the company. The legal statuses of ECF backers are currently unclear in company law. Backers should be allotted shares in the entity and backers should be able to participate in General and Extraordinary Meetings of the ECF. ECFs should be managed like any company with a proper Board of Directors, independent directors and a capable Audit Committee for better governance.

The Case for Accounting Standards and Assurance

“Regulation Crowdfunding” issued by the Securities and Exchange Commission (SEC) of the United States (US) in 2015 requires all financial statements of ECF entities to include balance sheets (also known as statements of financial position), statements of comprehensive income, statements of cash flows and statements of changes in owners' equity prepared in accordance with generally accepted US accounting principles (GAAP). Financial statements prepared in accordance with a comprehensive basis of accounting other than U.S. GAAP, special purpose frameworks and Private Company Council alternatives will not be acceptable. An independent public accountant or auditor must review and audit the financial statements of the ECF like traditional companies. The US regulators are very particular about the adoption of approved accounting standards for the preparation of accounts and proper practices when it comes to assurance. In Malaysia, the regulators are silent as to which accounting standards should be used when preparing crowdfunding accounts – i.e. the more comprehensive Malaysian Financial Reporting Standards (MFRS) or the Malaysian

Private Entities Reporting Standard (MPERS). In normal practice, the MFRS is adopted by non private entities and the MPERS by private entities. The Writer feels that the MFRS is more suited to crowdfunding entities as crowdfunding sources funds from the general public. Looking at the practices of traditional fund institutions such as banks and insurance companies, all these institutions adopt the MFRS when preparing their financial statements. The same rigour should be applied to crowdfunding establishments for the protection of their backers.

In Malaysia, paragraph 12.23 of the Guidelines on Recognized Markets issued by SC requires any crowdfunding issuer to submit audited financial statements (for offerings above RM500,000 or for issuers that have been established for at least 12 months), or management certified financial statements where audited financial statements are not available (e.g. for newly established issuers) to the ECF operator before the fund can be hosted. However, this is not enough. Assurance should be a continuous process. Not only should the audited or certified report be required when the fund is initially hosted but also at every financial year end. Again, it would be pointless that the ECF operator gets to read these reports. These reports should be made available in print or online to all backers. How would the backers know the performance of the projects when the backers cannot easily get the financial results of their investment? Investment appraisal techniques applied to conventional businesses cannot be used if accounts (which should have been audited) are not easily available to backers and potential backers. The suggestion is that the SC think about setting up a web-based depository like what Bursa Malaysia does so that the public can access the audited financial statements of the funds.

The Case for Non-equity Crowdfunding

Earlier, the issues pertaining to ECF were discussed whereby backers put in funds to help fund a project or business in a manner similar to the traditional company. What is the case for crowdfunding projects whereby the whole purpose of the venture is not-for-profit and for the betterment of the public? The writer's opinion is that non-equity crowdfunding (a term introduced by this paper) operates like societies or non-profit organisations. In Malaysia, societies and non-profit organisations are governed by the Societies Act 1966. Registered societies are required to keep proper accounts and to publish and file their audited financial statements with the Registrar of Societies. Members of the registered society will vote whether to buy off the financial statements or not in a general meeting.

There are currently no such requirements for non-equity crowdfunding; in fact, there are no laws in Malaysia governing such organisations. Even in the United States, there are no regulations pertaining to the governance of such projects. As there are no regulations pertaining to the governance, no government department tracks the performance of these projects. These are "businesses" that operate outside the official government statistics. Backers of the "Voyager Golden Record" are given project updates. Financial reports have yet to be published to the backers at the time of writing.

There are some who that argue that certain forms of non-equity crowdfunding such as case donations for disaster relief and personal medical pleas should not be regulated.Currently, similar forms fundraising are not fully regulated. Regulators would prefer the donors to channel their funds to approved institutions under Section 44(6) of the Income Tax Act 1967. Donors of institutions which have not been approved would not be entitled to a tax deduction. This does not stop people from donating. The suggestion is not the banning of all unregulated non-equity crowdfunding. Instead, the suggestion is amendment to Section 44(6) of the Income Tax 1967 to cover non-equity crowdfunding. The current rules to register institutions as charities under Section 44(6) are cumbersome. Simpler regulations to regulate non-equity crowdfunding are needed under the Income Tax Act 1967.

There is a need for non-equity crowdfunding to be regulated. Forbes reported that the size of crowdfunding in the United States was $2.1 billion in 2015. By 2016, $3.5 to $4 billion was raised through this platform. The growth rate was 75-100%. With the current growth rate, one day, crowdfunding would be as large as conventional funding. The World Bank predicted that by 2025, crowdfunding investments will be a $96 billion a year market in developing countries alone. Without proper financial reporting, assurance and governance rules, unscrupulous promoters might use the platform to swindle the public, to conduct illegal activities or to money-launder. Again, the authorities must revisit current laws pertaining to societies to make sure that non-equity crowdfunding is properly regulated like the traditional societies and non-profit organisations.

CONCLUSION

To fulfil the ever changing needs for corporate finance, practitioners of finance will come out with new methods of financing to suit the needs of current businesses. Crowdfunding is a form of alternative funding. Alternative funding such as "blockchain", "cryptocurrencies" and "money games" have been in the news recently. "Money games" have both the elements of gambling and alternative funding. "Money games" have been known to use some of the funds collected towards the running of businesses such as mini-markets, film studios, malls and hotels. It is the job of legislators and regulators to update current rules pertaining to accounting, governance and assurance to include all new forms of alternative funding for the protection of backers and investors. The U.S. Congress is now trying to come out with laws to regulate illegal cryptocurrency public coin offerings. In the 1980s, the Malaysian Chinese community pooled funds to invest in large cooperatives. The run on cooperatives prompted Bank Negara Malaysia in 1986 to regulate cooperatives. The cooperatives have now been absorbed into the traditional banking system. In time to come, alternative funding such as "crowdfunding" will be better regulated and will soon mature and become part of traditional finance.

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