



# Cabinet Economic Growth and Infrastructure Committee

EGI (13) 129

Copy No: 34

## Summary of Paper

8 July 2013

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### Financial Statements Assurance for Large and Medium Charities

**Portfolio** Commerce

**Purpose** This paper proposes the introduction of a statutory requirement for the largest 11 percent of the 26,000-odd registered charities to have their annual financial statements independently audited or reviewed.

**Previous Consideration** On 13 February 2013, EGI agreed to the release of a discussion paper on *Auditing and Assurance for Large and Medium Registered Charities – Concrete Proposals* [EGI Min (13) 1/4].

**Summary** Since 2008/09, registered charities have been required to file annual returns under the Charities Act 2005, and to attach financial statements to those annual returns. There is no statutory requirement for the financial statements to be independently assured. However, many charities, particularly larger ones, choose to have assurance engagements completed, or they are required to do so as a condition of receiving funding.

There is a consensus in the charities sector that an assurance requirement for large registered charities would contribute to maintaining and strengthening public confidence in the sector. These benefits need to be weighed against the extra costs associated with engaging qualified accountants to carry out the assurance engagement.

Following a consultation process, it is proposed to require:

- large charities to have their financial statements audited (a charity will be “large” if its operating expenditure (OPEX) was \$1 million or more for both of the last two financial years);
- medium charities to have their financial statements reviewed or audited (a charity will be “medium” if it is not large and its OPEX was \$500,000 or more for both of the last two financial years);
- the assurance engagements to be carried out by qualified accountants.

Around 2,800 registered charities are “large” or “medium”.<sup>1</sup> About 80 percent of these large or medium charities are already having an assurance engagement completed.

<sup>1</sup> There are around 26,000 entities on the charities register – most are small or very small (see table on page 2).

Compliance costs associated with these proposals are estimated to be about \$4.4 million per annum. While intangible and not able to be reliably quantified, the benefits are considered to exceed these costs.

It is also proposed that the Department of Internal Affairs be given responsibility for monitoring registered charities' compliance with the accounting standards, using a risk-based approach. This activity would commence in 2016. Further advice will be submitted to the Cabinet Social Policy Committee by 31 March 2015 on funding options for this monitoring activity.

<b>Regulatory Impact Analysis</b>	A Regulatory Impact Statement (RIS) is on pages 11-33. The Ministry of Business, Innovation and Employment considers that the RIS meets the quality assurance criteria.
<b>Baseline Implications</b>	None from this paper.
<b>Legislative Implications</b>	The proposed changes will be included in the Accounting Infrastructure Reform Bill, which has a category 5 priority (to be referred to a select committee in 2013) on the 2013 Legislation Programme.
<b>Timing Issues</b>	None.
<b>Announcement</b>	The Minister of Commerce and the Minister for the Community and Voluntary Sector will issue a media statement.  This paper will be posted on MBIE's website.
<b>Consultation</b>	Paper prepared by MBIE. DIA, Inland Revenue, Treasury, the External Reporting Board and the Office of the Auditor-General were consulted. DPMC was informed.  The Minister of Commerce indicates that the Minister of Internal Affairs and the Minister for the Community and Voluntary Sector were consulted, and that discussion is not required with the government caucus or with other parties represented in Parliament.

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## The Minister of Commerce recommends that the Committee:

### Background

- 1 note that the main purpose of the registration, reporting and monitoring system under the Charities Act 2005 is to promote charities' accountability to donors and taxpayers;
- 2 note that, consistent with the accountability goal, registered charities are required to lodge an annual return and to attach financial statements to the annual return;
- 3 note that:
  - 3.1 in September 2011, Cabinet agreed that the External Reporting Board would issue accounting standards for registered charities [EGI Min (11) 19/1];

3.2 in February 2013, the Cabinet Economic Growth and Infrastructure Committee agreed to the release of a discussion paper on *Auditing and Assurance for Large and Medium Registered Charities – Concrete Proposals* [EGI Min (13) 1/4];

4 note that the aims of introducing accounting standards for registered charities are to:

4.1 remove uncertainty for preparers who do not know what is expected of them;

4.2 improve the quality of reporting;

4.3 increase comparability between charities;

4.4 maintain and strengthen public confidence in the charity sector;

### **Auditing and assurance for registered charities**

5 note that the quality of reporting and public confidence in charity is further strengthened when charities have their financial statements independently assured by qualified accountants;

6 agree to:

6.1 require large charities to have their financial statements audited;

6.2 require medium charities to have their financial statements reviewed or audited;

6.3 not regulate assurance for small charities.

7 agree that:

7.1 a charity will be large if its operating expenditure (OPEX) was \$1 million or more for both of the last two financial years;

7.2 a charity will be medium if it is not large and its OPEX was \$500,000 or more for both of the last two financial years;

8 note that the dollar amounts have been determined following extensive consultation with the not-for-profit sector, including two discussion papers, workshops in 2012 and nationwide seminars in 2013;

9 note that about 2,800 out of 26,000 registered charities have OPEX of \$500,000 or more;

10 note that officials estimate that:

10.1 about 80 percent of those 2,800 charities already have assurance engagements carried out, although some are not being performed by qualified accountants;

10.2 the annual compliance costs will be about \$5.5 million;

11 agree:

11.1 to a regulation-making power that would provide for the dollar amounts to be increased in accordance with movements in the Consumers Price Index (CPI) no less than eight years since the current amounts were established or brought into effect;

- 11.2 that the CPI-adjusted amounts will be able to be rounded;
- 12 agree that the audit and assurance engagements for large and medium charities will need to be carried out by qualified accountants;
- 13 agree that there be no regulation of those who assure small charities' financial statements;
- 14 agree that no prohibitions are needed in relation to the possible misuse of "audit", "assurance", and other terms defined in auditing and assurance standards;

### **Monitoring of compliance with accounting standards**

- 15 agree in principle, subject to the report referred to in paragraph 16 below, that the Department of Internal Affairs start monitoring registered charities' compliance with accounting standards from 2016;
- 16 invite the Minister for the Community and Voluntary Sector to report to the Cabinet Social Policy Committee by 31 March 2015 on funding options for monitoring activity;
- 17 note that the funding options may require a review of the levy system on charities;

### **Legislative implications**

- 18 note that the Accounting Infrastructure Reform Bill has a category 5 priority (to be referred to a select committee in 2013) on the 2013 Legislation Programme;
- 19 invite the Minister of Commerce to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above paragraphs;
- 20 authorise the Minister of Commerce to make changes, consistent with the policy framework outlined in the paper under EGI (13) 129, on any issues that arise during the drafting process;

### **Publicity**

- 21 note that the Minister of Commerce and the Minister for the Community and Voluntary Sector will issue a press release on the main elements of Cabinet's decisions;
- 22 note that the Ministry of Business, Innovation and Employment will post a copy of the paper under EGI (13) 129 on its website.

Janine Harvey  
Committee Secretary

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**Distribution: (see over)**

**Distribution:**

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The Chair  
**Cabinet Economic Growth and Infrastructure Committee**

## **Financial Statements Assurance for Large and Medium Charities**

### **Proposal**

- 1 This paper proposes the introduction of a statutory requirement for the largest 11% of the 26,000-odd registered charities to have their annual financial statements independently audited or reviewed.

### **Executive Summary**

- 2 Registered charities have been required to file annual returns (including financial statements) under the Charities Act 2005 since 2008/09. A purpose of the annual return is to promote transparency and accountability by registered charities to:
  - a. Donors – Registered charities received public donations of \$1.05 billion in 2010/11.
  - b. Taxpayers – Registered charities obtain an income tax exemption which Inland Revenue estimates has a direct fiscal cost of \$350-400 million a year.
- 3 All registered charities are required to attach financial statements to the annual returns they lodge under the Charities Act. There is no requirement for the financial statements to be independently assured. However many charities, particularly larger ones, choose to have assurance engagements completed or are required to do so as a condition of receiving funding.
- 4 Assurance increases the value of financial reports because it provides users with more confidence that the financial statements have been prepared in accordance with generally accepted accounting practice (GAAP). More broadly, assurance underpins the trust and obligation of stewardship between those who manage the entity and those who need GAAP-compliant financial statements for decision-making and/or accountability purposes. There is a consensus in the charities sector that an assurance requirement for large registered charities would contribute to maintaining and strengthening public confidence in the sector. Those benefits need to be weighed against the extra costs associated with engaging qualified accountants to carry out the assurance engagement.
- 5 That weighing is relatively easy to do at both ends of the size spectrum. It is clear that independent assurance is of net benefit for the largest charities like the Order of St John, the Salvation Army and the Royal New Zealand Plunket Society. It is also clear that the costs exceed the benefits for the two-thirds of registered charities with annual operating expenditure of less than \$100,000 because the assurance expense to total expense ratio for those charities is high. A cut-off point somewhere between is needed.

## In Confidence

- 6 I am recommending the following:
- a. To require large charities to have their financial statements audited. A charity will be large if its operating expenditure (OPEX) was \$1 million or more for both of the last two financial years.
  - b. To require medium charities to have their financial statements reviewed or audited. A charity will be medium if it is not large and its OPEX was \$500,000 or more for both of the last two financial years.
  - c. To require the assurance engagements to be carried out by qualified accountants.
- 7 2,800-odd registered charities are large or medium and about 80% are already having an assurance engagement completed.
- 8 Officials have estimated the compliance costs associated with these changes to be about \$5.5 million a year. The benefits are intangible and cannot be reliably quantified. However, I am satisfied that the benefits exceed the costs because there has been extensive consultation and there is a consensus in the charities sector that the \$500,000 and \$1 million thresholds are broadly appropriate.
- 9 I am also recommending that the Department of Internal Affairs (DIA) be given responsibility for monitoring registered charities' compliance with the accounting standards, using a risk-based approach. This activity would commence in 2016.

### Background and problem

- 10 There are about 26,000 entities on the charities register. Table One shows that most are small or very small. 13% of registered charities spend less than \$1,000 a year. 33% spend less than \$10,000 a year. At the other extreme, only 1% spent \$10 million or more.

**Table One: Registered Charities**

Operating expenditure	Number of charities	Percentage of charities
Total	25,820	100%
≥\$1,000	22,420	87%
≥\$10,000	17,342	67%
≥\$100,000	7,434	29%
≥\$400,000	3,235	13%
≥\$500,000	2,772	11%
≥\$1 million	1,614	6%
≥\$2 million	980	4%
≥\$10 million	220	1%

- 11 All registered charities are required to attach financial statements to their annual returns under the Charities Act. The quality of reporting is mixed, mainly because many preparers, particularly volunteer treasurers, do not know what is expected of them. This issue is mainly being dealt with in the Financial Reporting Bill by empowering the External Reporting Board (XRB) to issue accounting standards for registered charities. The XRB is planning to bring the standards into force for financial years commencing on or after 1 April 2015, subject to the Bill being enacted in late 2013 or early 2014.



## In Confidence

- 12 However, accounting standards are not a complete solution, because preparers sometimes make mistakes or engage in accounting fraud. Errors can arise, for example, because the preparer misinterprets a standard or does not have a good understanding of a standard. In addition, some charities actively hide assets and income to look poor in an effort to obtain more funding, for example, by holding assets in subsidiary trusts and not preparing consolidated financial statements. Independent assurance reduces the risks that financial statements contain material errors, whether due to error or fraud.
- 13 A 2010 PhD thesis, which studied reporting practices by some large charities that employ accountants, documented several forms of accounting treatment which are inconsistent with professional standards and/or generally accepted accounting practice. The practices included transferring assets and income to subsidiary trusts and not consolidating, not including donated assets on the balance sheet or expensing them as soon as they are received, moving bank accounts off balance sheet when the balances become large, and keeping parallel accounting records outside the entity's formal records-keeping systems (e.g. separate asset registers and grants spread sheets). The main aim of these practices is to "look poor" to attract more funding.
- 14 To summarise, the main issue is that registered charities obtain almost \$1.5 billion from donors and taxpayers each year but there is not a commensurate level of charity accountability.

### The specific issues

- 15 The specific issues discussed in this paper are:
  - a. Mandatory assurance
  - b. Auditor qualifications
  - c. Monitoring of charities' compliance with accounting standards
  - d. Compliance issues for charities dealing with government funding agencies
  - e. Secondary issues.

### Mandatory assurance

- 16 There are two main benefits of mandatory assurance: the additional transparency and accountability benefits obtained by donors and taxpayers, and the reputational benefits for the charities sector as a whole. Independent assurance by a qualified accountant is also useful for the Inland Revenue Department from a monitoring and investigation perspective because they can treat the financial statements as being authoritative.
- 17 There are two material costs: the cost of assurance engagements that would not otherwise take place and the increased cost for charities that are currently obtaining assurance from unqualified persons.
- 18 It is clear that the costs exceed the benefits for small registered charities because in most cases the assurance cost will represent a high proportion of the charity's total operating expenditure. On the other hand, the benefits clearly exceed the costs for registered charities with annual expenditure of tens or hundreds of millions of dollars. There is a need to establish a criterion which approximates the point at which the marginal benefits of mandatory assurance start exceeding the marginal costs. There is also a choice to be made between requiring all entities above a certain dollar amount to have an audit carried out or whether to have a two-tier system which permit "less large" charities to choose between an audit and a review.

## In Confidence

- 19 There are differing views on this issue. Some stakeholders consider that a review is of little value because it is not sufficiently thorough. An alternative view is that a review can be a better option for some uncomplicated charities (e.g. charities that do not have varied income and expenditure streams, are only redistribution points and/or have no trading operations). Most large charities do not have these characteristics. I am satisfied that lower entity size is a good proxy for whether a review may be a cost effective alternative to an audit. Accordingly, I am proposing the following two tier system:
- a. Large charities would have their financial statements audited. A charity will be large if its OPEX was \$1 million or more for both of the last two financial years.
  - b. Medium charities would have their financial statements reviewed or audited. A charity will be medium if it is not large and its OPEX was \$500,000 or more for both of the last two financial years.
- 20 Of the roughly 26,000 registered charities, about 2,800 have OPEX of \$500,000 or more a year. Of those, about 1,600 have OPEX of \$1 million or more a year.
- 21 A small number of submitters stated that charities which are wholly privately funded should be exempt from these requirements on the grounds that they have no donor accountability. However, I consider that there is accountability to taxpayers because of the income tax exemption that is obtained through registration under the Charities Act.

### Auditor qualifications

- 22 An audit is not just about checking the numbers and confirming them against the financial records. Many of the issues that arise in an audit, particularly those involving valuations or assumptions about the future, involve estimates to which the auditor must bring their professional judgment. Consequently, assurance providers need:
- a. To understand accounting and assurance principles
  - b. Knowledge of accounting standards and audit and assurance standards issued by the XRB
  - c. The skills to identify the risks that could lead to a material misstatement in the specific circumstances of that engagement
  - d. The ability to determine what audit evidence is needed and the analytical skills to evaluate the evidence
  - e. The professional judgment to form an overall conclusion.
- 23 It is clear that auditors need to be qualified accountants. I am therefore proposing that the same auditor qualification requirements that apply to companies should also be applied to audits of medium and large charities and reviews of medium companies. I am not proposing any qualification requirements in relation to assurance for small charities, given that those engagements will not be regulated.

### Overall costs and benefits

- 24 Officials estimate that the compliance costs will be about \$5.5 million a year comprising:
- a. \$1 million for medium and large charities that are having "assurance" engagements carried out but are not being performed by qualified accountants. Many charities that need to change their provider will need to pay more than they are currently paying. Officials have estimated an average increase of \$2,000 for about 500 charities.

## In Confidence

- b. \$4.5 million a year for medium and large registered charities that are not currently having an assurance engagement carried out. This amount is based on an average cost of \$8,000 per engagement for 560 charities.
- 25 The benefits cannot be reliably quantified. However, as outlined in the consultation section later in this paper, there has been extensive consultation through two discussion papers, along with a seminar series held in association with the first paper and a nationwide road show for the second. There has been largely positive feedback on the second paper, which proposed criteria of \$1 million and \$400,000 OPEX. This provides a good indication that the charity sector considers that the benefits outweigh the costs at those levels. However, I am recommending that \$400,000 be changed to \$500,000 because of concerns that the cost of assurance may be too high a proportion of gross earnings for some trading charities at the \$400,000 level.

### Secondary issue: Mechanism to increase thresholds

- 26 The dollar amounts that define whether a charity is medium or large should be increased from time-to-time to remove the risks of small charities being drawn into the medium tier and medium charities into the large tier due only to inflation. I am proposing a regulation-making power that would provide for changes to be made broadly in line with movements in the Consumers Price Index no less than eight years after the current amounts were set. This approach will be consistent with a provision in the Financial Reporting Bill for related purposes.

### Secondary issue: Use of terms defined in auditing and assurance standards

- 27 One submission noted that the terms "audit", "assurance" and related terms are being used inappropriately. Those terms have specific meanings under auditing and assurance standards issued by the XRB and indicate that certain procedures and processes have been followed. However, those terms are sometimes used when the procedures and processes have not been carried out, leading to concerns that users of the financial statements may take more comfort from the financial report than is warranted.
- 28 I consider that there is no need to change the law in relation to this matter. The predominant cause appears to be lack of knowledge rather than wilful disregard of auditing and assurance standards. If anything needs to be done, it would seem more appropriate for the relevant experts to consider education options.

### Comparison with Australia

- 29 The Australian Charities and Not-for-profits Commission Act 2012 was passed on 1 November 2012 and the Commission commenced operations on 3 December 2012. The key provisions in the Act relating to assurance are conceptually the same as proposed in this paper, being a two-tier system of audit for large charities and audit or review for medium-sized charities and with a requirement for the engagements to be carried out by qualified accountants. The only significant differences relate to:
- a. The metric used to define whether a charity is large, medium or small – Australia uses annual revenue, not OPEX. I am satisfied that OPEX best fits New Zealand's circumstances for two reasons. First, expenditure is good measure of the economic impact of not-for-profit entities because those expenditure and revenue tend to even out in the long run in that sector. Second, charitable entity revenue tends to fluctuate much more from year-to-year than expenditure. The risks that charities will fluctuate between the tiers are lower with OPEX.

## **In Confidence**

- b. The dollar amounts – The Australian amounts to define medium and large charities are A\$250,000 and A\$1 million, compared with NZ\$500,000 and NZ\$1 million. About 22% of registered entities are subject to mandatory assurance in Australia, compared with the proposed 11% in New Zealand.
- 30 Overall, the proposals in this paper are broadly compatible with the rules in Australia.

### **Government funding agency issues**

- 31 Some stakeholders expressed concern about the administrative burdens of dealing with more than one government funding agency. It is clear that there is frustration about differences in funding application processes and forms and different rules relating to various requirements, including the rules relating to financial statement audit requirements. There is also a sense from charities receiving funding from two or more sources that government agencies should coordinate programmes that are aimed at evaluating whether the funds are being used for the intended purposes.
- 32 MBIE is leading a three year programme (2013-2016) "Streamlined Contracting with NGOs" which aims to reduce duplication by government agencies and reduce the compliance cost burden on NGOs. A suite of contract, contract management and decision-making documents (collectively referred to as the contracting framework) has been developed. It should create greater consistency within government to assessing contracting risks, the form of contract and the approach to contract management for contracts between government agencies and NGOs. Within the contracting framework there is a commitment by government purchasing agencies to reduce the duplication of audit and monitoring-related activities.
- 33 MBIE is currently working with government funding agencies to begin the process of transitioning them to the new contracting framework, which should see a reduction in the duplication of audit and monitoring activity being undertaken by government agencies when dealing with NGOs.

### **Monitoring of charities' compliance with accounting standards**

- 34 DIA monitors annual returns to check whether the entity remains eligible for registration. The monitoring does not include checking the financial statements because there are no applicable accounting standards. As noted earlier, it is expected that not-for-profit accounting standards issued by the XRB will become mandatory for registered charities for financial years beginning on or after 1 April 2015.
- 35 Accounting standards issued by the XRB are deemed regulations and have the force of law. For those financial statements that are audited or reviewed, the assurance provider will express an opinion about whether the financial statements comply with applicable accounting standards. However, there are two gaps:
- a. Compliance with the accounting standards by small entities that do not have their financial statements assured – The rate of compliance with the standards is likely to be lower if there is no monitoring.
  - b. Compliance with the financial reporting-related conditions imposed on entities that are registered under the group registration provisions in the Charities Act – Those conditions specify whether consolidated financial statements or financial statements for each individual entity are to be lodged. It is important for users that the lodged financial statements comply with the conditions.

## In Confidence

- 36 The higher quality reporting associated with monitoring should also enhance the reputation of the sector and will particularly benefit the majority of charities that will comply with the new financial reporting standards.
- 37 I am recommending that Cabinet agree in principle to supplement the statutory-based assurance regime with monitoring by DIA commencing in 2016, subject to more specific proposals being developed by DIA. This would involve checking compliance with applicable accounting standards using a risk-based approach. Under this approach, all charities could be potentially monitored for compliance with the standards. However, the focus will be higher risk entities such as those that have a history of non-compliance with accounting standards, poor governance, or engage in significant commercial activities.
- 38 The cost of the activity will depend on the operational details of the system. Options for funding include an adjustment of baselines, reprioritisation of funding, an annual levy on registered charities, or a combination of approaches.
- 39 DIA Charities Services is already partly funded by a fee of \$51.11 (GST inclusive) on charities with income of \$10,000 or more. That levy generates about \$750,000 a year (GST exclusive). The possibility of adjusting the levy to meet the monitoring costs would provide an opportunity to consider whether a flat levy for \$10,000-plus charities remains appropriate. Some charities will view any increase in fees with concern. However, a general review of the levy system provides an opportunity to ensure it remains moderate and equitable.
- 40 The Minister for the Community and Voluntary Sector and I agree that DIA should develop options for funding the monitoring activity, which may require a review of the levy system, and report back to the Cabinet Social Policy Committee by 31 March 2015.

### Monitoring and enforcement

- 41 DIA will have a number of options in the event of non-compliance with accounting standards. As a general rule, a low key approach is taken. However, in some cases non-compliance with accounting standards may lead to:
- a. Deregistration of the entity; and/or
  - b. Reference to the Police where fraud may be involved.
- 42 In addition, non-compliance with accounting or auditing and assurance standards by a chartered accountant could lead to the matter being referred to the New Zealand Institute of Chartered Accountants for investigation.

### Consultation

- 43 The following government agencies have been consulted: the Department of Internal Affairs, Department of Inland Revenue, Treasury, External Reporting Board and Office of the Auditor-General. The Department of Prime Minister and Cabinet was informed.
- 44 There has been extensive consultation with the charities sector. The Ministry of Economic Development issued a preliminary proposals discussion paper in April 2012. Workshops were held in five centres while the paper was open for comment and more than 200 people participated. That paper proposed mandatory audit for charities with OPEX of \$300,000 or more and mandatory audit or review for \$200,000 to \$300,000 charities. 58 submissions were received. Most submissions stated that both dollar amounts needed to be substantially increased.

## **In Confidence**

45 MBIE released a follow-up discussion paper in February 2013, instead proposing \$400,000 and \$1 million. MBIE participated in a road show on this paper which combined consultation on the two draft simple format reporting standards for not-for-profit entities which were released by the XRB in December 2012. There were 23 seminars in 15 locations from March to May 2013 and about 2,000 people attended. 27 submissions were received. There was broad support for the main proposals in the second discussion paper.

### **Financial Implications**

46 The proposal to introduce a new function for DIA to monitor charities' compliance with applicable accounting standards from 2016 onwards will have financial implications. However, there are no financial recommendations in this paper because the details of the monitoring system and the means of funding it would not be determined until 2015.

### **Human Rights**

47 There are no human rights implications.

### **Legislative Implications**

48 The proposal to introduce a mandatory audit and assurance requirement for medium and large charities will require an amendment to the Charities Act 2005. These changes will be included in the Accounting Infrastructure Reform Bill, which has a Category 5 priority (to be referred to a select committee in 2013).

### **Regulatory Impact Analysis**

49 The regulatory impact analysis requirements apply to these proposals. A regulatory impact statement (RIS) has been prepared and is attached to this paper.

### **Quality of the Impact Analysis**

50 The General Manager, Strategic Policy Branch and the Ministry of Business, Innovation and Employment Regulatory Impact Analysis Review Panel have reviewed the attached RIS prepared by the Ministry of Business, Innovation and Employment, and consider that the information and analysis summarised in the RIS meets the criteria necessary for ministers to fairly compare the available policy options and take informed decisions on the proposals in this paper.

### **Publicity**

51 The Minister for the Voluntary and Community Sector and I will release a media statement. MBIE will place a copy of this paper on its website, subject to approval of recommendation 22 below.

## In Confidence

### Recommendations

I recommend that the Committee:

#### *Accounting standards for registered charities*

- 1 **note** that the main purpose of the registration, reporting and monitoring system under the Charities Act 2005 is to promote charities' accountability to donors and taxpayers;
- 2 **note** that, consistent with the accountability goal, registered charities are required to lodge an annual return and attach financial statements to the annual return;
- 3 **note** that Cabinet agreed in September 2011 that the External Reporting Board would issue accounting standards for registered charities [EG] Min (11) 19/1];
- 4 **note** that the aims of introducing accounting standards for registered charities are to remove uncertainty for preparers who do not know what is expected of them, improve the quality of reporting, increase comparability between charities and maintain and strengthen public confidence in the charity sector;

#### *Auditing and assurance for registered charities*

- 5 **note** that the quality of reporting and public confidence in charity is further strengthened when charities have their financial statements independently assured by qualified accountants;
- 6 **agree:**
  - 6.1 To require large charities to have their financial statements audited;
  - 6.2 To require medium charities to have their financial statements reviewed or audited;
  - 6.3 To not regulate assurance for small charities;
- 7 **agree that:**
  - 7.1 A charity will be large if its operating expenditure (OPEX) was \$1 million or more for both of the last two financial years;
  - 7.2 A charity will be medium if it is not large and its OPEX was \$500,000 or more for both of the last two financial years;
- 8 **note** that the dollar amounts have been determined following extensive consultation with the not-for-profit sector, including two discussion papers, workshops in 2012 and nationwide seminars in 2013;
- 9 **note** that about 2,800 out of 26,000 registered charities have OPEX of \$500,000 or more;
- 10 **note** that officials estimate that:
  - 10.1 about 80% of those 2,800 charities already have assurance engagements carried out, although some are not being performed by qualified accountants;
  - 10.2 the annual compliance costs will be about \$5.5 million;

## In Confidence

11 **agree:**

11.1 To a regulation-making power that would provide for the dollar amounts to be increased in accordance with movements in the Consumers Price Index no less than eight years since the current amounts were established or brought into effect;

11.2 That the CPI-adjusted amounts will be able to be rounded;

12 **agree** that the audit and assurance engagements for large and medium charities will need to be carried out by qualified accountants;

13 **agree** that there will no regulation of those who assure small charities' financial statements;

14 **agree** that no prohibitions are needed in relation to the possible misuse of "audit", "assurance" and other terms defined in auditing and assurance standards;

*Monitoring of compliance with accounting standards*

15 **agree** in principle that the Department of Internal Affairs will start monitoring registered charities' compliance with accounting standards from 2016;

16 **invite** the Minister for the Community and Voluntary Sector to report to the Cabinet Social Policy Committee on funding options for monitoring activity by 31 March 2015;

17 **note** that the funding options may require a review of the levy system on charities;

*Legislative implications*

18 **note** that the Accounting Infrastructure Reform Bill has a category 5 (to be referred to a select committee in 2013) on the 2013 Legislation Programme;

19 **invite** the Minister of Commerce to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above changes;

20 **authorise** the Minister of Commerce to make changes, consistent with the policy framework outlined in this paper, on any issues that arise during the drafting process;

*Publicity*

21 **note** that the Minister of Commerce and Minister for the Community and Voluntary Sector will issue a press release on the main elements of Cabinet's decisions;

22 **note** that the Ministry of Business, Innovation and Employment will post a copy of this paper on its website, subject to any amendments to the paper that may be necessary in the light of discussions at the meeting.



Hon Craig Foss  
Minister of Commerce

30, 6, 13



# Regulatory Impact Statement

## Financial statements assurance for large and medium charities

### Agency Disclosure Statement

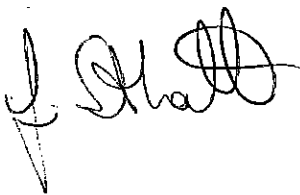
This Regulatory Impact Statement has been prepared by the Ministry of Business, Innovation and Employment.

It provides an analysis of options to strengthen public confidence in the charitable sector through a statutory requirement for medium and large charities to have their financial statements audited or reviewed.

The main constraint on the analysis is that the benefits of imposing mandatory assurance (i.e. improved accountability to donors and taxpayers, and increased public confidence in the charities sector) cannot be reliably quantified. However, we are satisfied that the preferred option provides an appropriate balance between costs and benefits because there is a consensus among stakeholders in favour of it. This is evident from extensive consultation comprising two discussion papers (a tentative proposals paper in 2012, and a follow-up concrete proposals paper in 2013) with workshops in 5 centres on the 2012 paper and participation on the 2013 paper in 23 seminars in 15 locations nationwide.

The data obtained from the Charities Register have a minor limitation. Registered entities have used many different bases for the preparation of financial statements, including bases that are inconsistent with generally accepted accounting practice. Nevertheless, our view is that the register is a very useful source of information and the data imperfections do not have a material impact on our analysis.

The preferred option will not impair private property rights, market competition, or the incentives on businesses to innovate and invest, or override fundamental common law principles. It could be argued that the proposals may impose small additional costs on businesses because it is likely that a small proportion of the 560 charities that are affected by these proposals are trading charities. Some of those trading charities may regard themselves as businesses, although our experience is that charities generally do not have this self-perception.



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## Introduction

- 1 This RIS is in two parts. Part one relates to mandatory assurance for registered charities. Part two relates to monitoring by the Department of Internal Affairs (DIA) of compliance by registered charities with accounting standards issued by the External Reporting Board (XRB).
- 2 MED/MBIE issued two discussion papers, in April 2012 and February 2013. They can be found at [www.med.govt.nz](http://www.med.govt.nz) and [www.mbie.govt.nz](http://www.mbie.govt.nz). They will both eventually appear on the MBIE website. In the meantime, a quicker way to find them is to google "MBIE charities assurance".

## Definitions

- 3 "Assurance", "audit", "review" and other related terms have specific meanings under auditing and assurance standards issued by the XRB and indicate that certain processes and procedures have been carried out. These and other related technical terms are defined in Appendix One.

## Background on charities regulation and financial reporting

- 4 Charity regulation internationally generally includes protecting the charity sector and the public against persons or entities falsely identifying themselves as charities or misrepresenting their purpose. It also typically requires charities to keep proper accounting and other records, and to disclose information about their purpose, recent activities, planned activities and financial position and performance. This information serves three main purposes:
  - a. To promote public confidence and trust in the charitable sector. This contributes to maintaining and growing the sector.
  - b. To help potential funders and donors to make informed decisions about the charities they will support.
  - c. To promote charities' accountability to the public by providing information about whether the funds or other assets they have obtained from the public are being used effectively and efficiently.
- 5 Registered charities have been required to file annual returns (including financial statements) under the Charities Act since 2008. Those annual returns promote accountability by registered charities to:
  - a. Donors – Registered charities received public donations of \$1.05 billion in 2010/11.
  - b. Taxpayers – Registered charities obtain an income tax exemption which Inland Revenue estimates has a direct fiscal cost of \$350-400 million a year.
- 6 General purpose financial reports can also be useful for those charged with governance of the entity. This is particularly the case in the NFP sector because the annual financial statements are often the only potentially useful information about the entity's financial position, financial performance and cash flows. This is because most NFP entities do not prepare any other type of financial statements (e.g. for tax purposes) and do not have the capacity to produce special purpose financial reports for governance purposes.

## Background on the charities sector

- 7 There are about 26,000 entities on the charities register. Table 1 demonstrates that most are small or very small. 13% of registered charities spend less than \$1,000 a year, 33% spend less than \$10,000 a year and 71% spend less than \$100,000 a year. Most do not have assurance carried out.

- 8 At the other extreme, less than 1% spent \$10 million or more in their latest financial year. Almost all charities of this size have their financial statements audited. We sampled 10% of the \$10 million-plus charities and 21 of the 22 had their financial statements audited. All 21 audits were carried out by accounting firms rather than individuals: 12 by Big 4 firms, five by mid-tier firms and four by other firms. Details of the search are attached as Appendix Two.

**Table 1: Registered Charities (search carried out on 14 May 2013)**

Operating expenditure	Number of charities	Percentage of charities
Total	25,820	100%
≥\$1,000	22,420	87%
≥\$10,000	17,342	67%
≥\$100,000	7,434	29%
≥\$400,000	3,235	13%
≥\$500,000	2,772	11%
≥\$600,000	2,411	9%
≥\$1 million	1,614	6%
≥\$2 million	980	4%
≥\$10 million	220	1%

## Part One: Assurance for registered charities

### Background

- 9 The Ministry has released two discussion papers on this issue. The discussion paper released in April 2012 tentatively proposed that registered charities with annual operating expenditure of:
- \$300,000 or more would be required to have their annual financial statements audited by a qualified accountant
  - \$200,000 or more and less than \$300,000 would be required to have their annual financial statements either audited or reviewed by a qualified accountant.
- 10 These proposals were largely opposed because we had underestimated the costs of assurance. We subsequently released a concrete issues discussion paper in February 2013 which proposed setting the amounts at \$1 million and \$400,000. There was broad support for these proposals.

### Assurance: The status quo and problem definition

#### The status quo – assurance

- 11 Registered charities are required to attach financial statements to the annual returns that they lodge under the Charities Act 2005. The Financial Reporting Bill, which is currently awaiting a second reading, will introduce a requirement for those financial statements to be prepared in accordance with accounting standards issued by the XRB.
- 12 There are no specific legislative requirements for registered charities to obtain any form of assurance over their financial statements, and none are proposed in the Financial Reporting Bill. Nevertheless, many charities, particularly larger ones, obtain assurance (usually an audit) because:

- a. It contributes to demonstrating to funders and donors that the charity is well managed and a trusted provider
- b. It is required under the charity's constitution or rules
- c. Some agencies require it as a condition of providing funding to the charity
- d. A small number are public entities as defined in the Public Audit Act 2001 or have an audit requirement under other legislation.

### **Status quo – assurance providers**

- 13 Charity assurance is performed by both accounting firms and individuals. The firms have various forms including partnerships and companies. The range of individuals is wide, comprising members of professional accounting bodies (including licensed auditors and those with 'retired' status), accountants who are not members of a professional accounting body and non-accountants. In practice some "audits" of financial statements prepared by charities are not audits at all, because they are not carried out in accordance with the standards issued by the XRB. This is particularly the case when the work is carried out by non-accountants.
- 14 Three Acts regulate certain classes of audits:
- a. The Auditor Regulation Act 2011 provides for the licensing of auditors and the registration of audit firms. However, it only applies to audits of issuers, banks, insurers, mutual funds and other entities that invest or manage assets on behalf of broad groups of outsiders in a fiduciary capacity. Few if any registered charity audits are subject to the Auditor Regulation Act.
  - b. A small number of charities are registered under the Companies Act 1994. Those that choose to have an audit carried out must have it conducted by:
    - i. A member of NZICA's College of Chartered Accountants who also holds a Certificate of Public Practice;<sup>1</sup>
    - ii. A person who is eligible to act as an auditor in an overseas jurisdiction and is a member, fellow or associate of an overseas professional accounting body that has been approved by the Registrar of Companies. Nine bodies have been approved; or
    - iii. A person who is eligible to act as an auditor in an overseas jurisdiction and has been approved by the Registrar. 29 approvals have been granted dating back to the mid-1990s, although it is likely that some are no longer practising.<sup>2</sup>
  - c. The Public Audit Act 2001 states that the Auditor-General is the auditor for all public entities. It also permits the Auditor-General to appoint persons or firms qualified to carry out audits under the Companies Act to carry out public entity audits. A small number of registered charities (e.g. universities) are public entities and are, therefore, subject to the requirements of the Public Audit Act.
- 15 In addition, a very small number of Acts require single entities which have also registered under the Charities Act to have their financial statements audited (e.g. the Nurse Maude Association Act 2000).

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<sup>1</sup> If an assurance practitioner is an NZICA member, he or she must hold a Certificate of Public Practice if his or her gross fees from offering accounting services exceed \$13,000 (excluding GST) a year.

<sup>2</sup> Cabinet has recently agreed to allow company audits to be carried out by members of professional bodies that have been accredited by the Financial Markets Authority under the Auditor Regulation Act 2011. CPA Australia has such accreditation. The intention is to introduce legislation that would give effect to this decision later this year.

- 16 Nothing prevents any person from providing assurance services to a charity where there are no statutory assurance requirements. This is the situation for the great majority of registered charities. Nevertheless, NZICA members are required to carry out all assurance engagements in accordance with auditing and assurance standards issued by the XRB regardless of whether they are statutory audits or not.
- 17 NZICA is currently developing an "Approved Auditor" status which, at a minimum, will lead to the regulation of assurance practitioners carrying out statutory assurance engagements (NZICA is also considering an extension of the scope to all assurance engagements). There will be a transitional period, and the designated start date will be determined after NZICA finalises the proposals.

### **The status quo – assurance pricing**

- 18 Some assurance engagements in the not-for-profit (NFP) sector are carried out at fully commercial rates, others at discounted prices and the remainder free-of-charge.

### **Generally accepted accounting practice**

- 19 Generally accepted accounting practice (GAAP) is defined by the accounting standards that are issued by the XRB. GAAP comprises a set of principles and rules that standardise the approach to the recognition and measurement of transactions. GAAP also standardises the minimum disclosure requirements and the format for presenting that information. Preparation in accordance with GAAP has several benefits. First, it means that the financial statements will have been compiled on a reliable basis. Second, it means that users who understand GAAP can readily analyse the information. Third, users can readily compare reporting entities because they are all using the same rules.
- 20 However, these three benefits are only fully achieved if users are confident that the standards are being complied with. Absent independent assurance, users of financial statements are fully reliant on the reporting entity to prepare the financial statements in accordance with GAAP. The advantage of having an assurance engagement is to provide an independent opinion on whether the financial statements are GAAP-compliant, or whether there are material misstatements due to error or accounting fraud.

### **The problem**

- 21 The main issue is that there should be appropriate levels of accountability and transparency by the charity sector in relation to the substantial amounts of money that it obtains from the public. This totals almost \$1.5 billion a year, comprising \$1.05 billion from donors and \$350-400 million from taxpayers in forgone revenue due to the income tax exemption associated with registration under the Charities Act. Financial reporting provides some of that accountability. However, there is no independent assurance requirement, which means that some charities are lodging financial statements that do not comply with GAAP, whether due to error or accounting fraud.
- 22 In addition, some audits and reviews are being carried out by individuals who lack the necessary knowledge, skills and experience to do them capably. This means that unmodified assurance opinions are being issued in inappropriate circumstances.
- 23 Three recent studies evidence these problems:

- a. Sinclair (2010)<sup>3</sup> found that there was poor knowledge of appropriate professional standards by accountants working in the charities sector. She also found that it is the aim of many charities to “look poor” as they seek to gain more funding.
  - b. Cordery & Patel (2011)<sup>4</sup> concluded that more than 40% of a sample of 300 registered charities prepared financial statements that were not in accordance with GAAP. 173 had assurance reports attached but more than a quarter of them were not in the appropriate format.
  - c. Cordery (2012)<sup>5</sup> found that about 20% of assurance reports in a sample of 837 registered charities were found to not be to a satisfactory standard. She also found that accounting firms and qualified individuals were more likely than unqualified individuals to provide an assurance report that was satisfactory.
- 24 Sinclair’s study only included charities that were large enough to be employing qualified accountants. She documents many examples of accounting treatment that are inconsistent with professional standards and/or generally accepted accounting practice. These include:
- a. transferring assets and income to subsidiary trusts and not preparing consolidated financial statements
  - b. not including bequests and donated assets on the balance sheet or expensing donating assets as soon as they are received
  - c. moving bank accounts off balance sheet when the balances became large
  - d. maintaining parallel accounting records outside the entity’s formal records-keeping systems (e.g. separate asset registers and grants spread sheets)
  - e. using inappropriate methods for valuing non-current assets, such as using historic cost where fair value should be used
  - f. not applying accrual principles to prepayments received from funding agencies.

## Objective

- 25 The objective is to find an appropriate balance between the benefits associated with increased quality and reliability of financial statements if they have been assured and the additional costs associated with having the assurance engagement completed.

## Regulatory impact analysis relating to mandatory assurance

### Issues

- 26 This paper addresses the following:
- a. Whether registered charities should be required by statute to have an assurance engagement carried out.
  - b. If yes:
    - i. Whether the registered charities subject to the assurance obligation should all be required to have an audit or whether review will also be permitted for some.

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<sup>3</sup> Rowena M S Sinclair, *Understandability and Transparency of the Financial Statements of Charities*, PhD thesis submitted to Auckland University of Technology (2010).

<sup>4</sup> Carolyn Cordery and Kapil Patel, *Financial Reporting Stocktake: An Assessment of Accountability through Charities’ Filing on New Zealand’s Charities Register*, Victoria University of Wellington (2011).

<sup>5</sup> Carolyn J Cordery, *Incidence of Auditing and Assurance in Charities*, Victoria University of Wellington (2012).

- ii. What measures should be used to identify those charities (e.g. revenue)
- iii. The dollar amounts that trigger the assurance obligation
- iv. Whether to have a power to change the dollar amounts from time-to-time.
- v. Assurance provider qualifications.

**Issue A: Whether registered charities should be required to have an assurance engagement carried out**

- 27 This section evaluates whether or not some or all registered charities should be required under legislation to have their financial statements independently assured. We have not considered whether such obligations should be imposed on small charities for compliance cost reasons. However, as outlined below, we do not consider these costs to be unrealistic for larger charities.
- 28 The main benefits and costs associated with a legislative requirement to have financial statements assured are summarised in Table 2.

**Table 2: The benefits and costs of requiring assurance in legislation**

Benefits	Costs
Improved accountability to donors and taxpayers and improved decision-making by donors	The cost of assurance engagements that would not otherwise take place
Reputational benefits for the charity sector as a whole. Evidence of good governance, including independent assurance, sends positive signals to the donating public.	The increased cost for charities which are currently obtaining assurance from unqualified persons

- 29 Mandatory assurance is also useful for the Inland Revenue Department from a monitoring and investigation perspective given that registrations under the Charities Act result in \$350-\$400 million in directly forgone income tax each year. This is because Inland Revenue can treat the financial statements as authoritative if they have been independently assured by a qualified accountant.
- 30 The balance between the costs and benefits of assurance varies for different entities depending on a number of factors. These factors include:
  - a. Whether the charity has varied income and expenditure streams, only earns money from an investment or is only a distribution point.
  - b. Whether it has trading operations and, if so, the nature of them.
  - c. The quality of its control systems and governance.
- 31 The most important determinant of the balance between the costs and benefits of assurance is entity size because there are both fixed and variable cost elements. The fixed costs arise because the practitioner must carry out certain preparatory work, including planning the audit and assessing where the most significant audit risks are likely to arise for each engagement. As a general rule, the ratio of fixed costs to total costs is lower for larger entity audits. The impact of the fixed/variable split can be illustrated by comparing a small registered charity with two large charities:
  - a. Total expenditure for the RG and EF MacDonald Trust Board was \$58,000 in the year ended 31 March 2012 and the audit fees were \$3,100. Thus, the cost of the audit was more than 5% of total expenditure.

- b. Total expenditure for the National Heart Foundation was \$13.2 million in the year to 30 June 2012 and the audit fees were \$35,000. The cost of the audit was less than 0.3% of total expenditure.
  - c. Total expenditure for the Nurse Maude Association was \$45 million in the year to 30 June 2012 and the audit fees were \$30,000. The cost of the audit was considerably less than 0.1% of total expenditure.
- 32 The main challenge in evaluating the costs and benefits of requiring assurance in legislation is that the benefits outlined in Table 2 cannot be reliably quantified. A qualitative judgment needs to be made about the value of assurance.
- 33 Our view is that it is clear that requiring assurance in legislation cannot be justified at anything like the 5% level illustrated by the MacDonald Trust Board example. However, we consider that it is also clear that the benefits to users outweigh the compliance costs for the two large charities. However, these are extreme examples. The next sections of this RIS discuss how to distinguish between the large and the small in ways that can be readily applied under statute.

**Issue B1: Whether the charities subject to the assurance obligation should all be required to have an audit carried out or whether review will also be permitted for some**

- 34 There are two types of financial statement assurance engagement:
- a. **Audit** (also called 'reasonable assurance' and 'positive assurance') – Auditing standards require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.
  - b. **Review** (also called 'limited assurance' and 'negative assurance') – A reviewer reports on whether anything has come to his or her attention to cause him or her to believe that the financial information does not comply with GAAP. A review report helps lend some credibility to the financial information by providing a moderate level of assurance that the financial information is not materially misstated. A review is based on enquiries and analytical procedures and the exercise of judgment. Therefore, there is an unavoidable risk that some material misstatements may remain undiscovered.
- 35 We considered two options:
- a. Whether all registered charities above a certain size should be obliged to have an audit carried out
  - b. Whether some registered charities will be permitted to have a review carried out as an alternative to an audit.
- 36 We proposed the latter option in both discussion papers.
- 37 The main argument for requiring all large and medium charities to have an audit carried out relates to concerns about whether a review adequately assures whether the financial statements are sufficiently reliable. An audit requires the practitioner to obtain sufficient evidence as the basis for a positive form of expression of his or her opinion (e.g. we believe the financial statements present a true and fair view). A review only requires a negative form of expression (e.g. we have not become aware of any matter to cause us to believe that the financial statements do not present a true and fair view). Thus, review procedures are less detailed and a review does not provide all the evidence that is required in an audit.



- 38 There are two main counterarguments:
- A review may suit an entity's assurance needs if its operations are reasonably simple. For example, a review may be the better option if the entity only has a small number of income and expenditure streams, only earns money from an investment fund or is just a redistribution point.
  - The Review Standard is currently being strengthened. It is likely that the XRB will issue a New Zealand equivalent to the strengthened international standard in 2014.
- 39 Overall, we consider that there is a case for allowing medium charities to choose between the two forms of assurance and that smaller entity size is a satisfactory proxy for the circumstances where review is likely to be the better assurance option. The Australian Charities and Not-for-profits Act 2012 uses the same two-tier approach.

**Issue B2: The criterion or criteria to be used to identify charities that will be subject to a legislative assurance requirement**

- 40 We considered four options: total revenue, total operating expenditure, total assets and full-time equivalent employees. Table 3 outlines the pros and cons of each option. Our preferred option is total operating expenses.

**Table 3: Measurement criteria**

Measure	Advantages	Disadvantages
Total revenue	<ul style="list-style-type: none"> <li>- Income is the best way to measure the economic impact of an entity.</li> <li>- Total income is used under the Australian Charities and Not-for-profits Act 2012.</li> </ul>	<ul style="list-style-type: none"> <li>- Income can fluctuate markedly from year-to-year in the NFP sector.</li> <li>- Alignment with Australia has few if any practical benefits. We are not aware of any NZ registered charities that are also reporting entities in Australia.</li> </ul>
Total operating expenses	<ul style="list-style-type: none"> <li>- Expenses are a good measure of economic activity in the NFP sector because revenue and expenses tend to even out in the long run.</li> </ul>	<ul style="list-style-type: none"> <li>- Expenses can fluctuate from year-to-year. However, the fluctuations are generally much smaller than is the case for income.</li> </ul>
Total assets	<ul style="list-style-type: none"> <li>- Assets could be useful as a secondary measure for high asset-low income/expense charities.</li> </ul>	<ul style="list-style-type: none"> <li>- Total assets are often not a good proxy for economic impact.</li> <li>- Use as a secondary measure may capture charities generate low levels of income.</li> </ul>
FTE employees	<ul style="list-style-type: none"> <li>- FTE employees could be a useful secondary measure</li> </ul>	<ul style="list-style-type: none"> <li>- FTE employees are often not a good proxy for economic activity. This is particularly so in the NFP sector because volunteers are not included.</li> </ul>

- 41 Revenue and expenses are the two best options by a considerable margin because they are much better measures of economic activity. Our preferred option is total expenses because of the concern about the degree to which revenue can fluctuate from year-to-year. Revenue fluctuations could be a significant problem for charities that are close to the assurance/no assurance threshold dollar amount. Using revenue could effectively oblige charities that are well below the threshold some years but above it in other years to have an assurance engagement carried out every year.<sup>6</sup>
- 42 We also considered whether there should be an assets-related test to supplement the total expenses test, but decided against it. We concluded that there was too much risk of requiring entities to have an assurance engagement completed without there being a public policy justification.
- 43 This is particularly an issue for entities whose purpose is to advance religion because many own valuable land and buildings that are not used for economic purposes. To illustrate, we analysed the financial statements lodged under the Charities Act by 75 parishes. The average total income was \$122,000, average total expenditure was \$119,000 and average total asset value was \$1.7 million. 43 of the 75 parishes had assets valued at more than \$1 million and 24 at more than \$2 million. We think it is clear that there is no justification for imposing a legislative assurance obligation on those registered charities given that the audit costs would need to come from the relatively small revenue amounts.

#### *A further guard against fluctuation risks*

- 44 The fluctuation issue does not go away with total expenditure, but it is usually much less pronounced. In order to reduce the risks further, we floated the option in the 2013 discussion paper that the assurance obligation would only be triggered if the charity was above the dollar threshold for both of the last two financial years.<sup>7</sup> All submitters who commented on this issue supported this proposal.
- 45 We conclude that the two year rule is appropriate.

#### **Issue B3: The dollar amounts that trigger the assurance obligation**

- 46 Having determined that total operating expenses is the best criterion and that a two tier system is appropriate, the next step is to determine the dollar amounts for defining the tiers. For simplicity purposes, we are referring to the higher tier as the large charity tier and the lower tier as the medium charity tier.
- 47 There are numerous options, although only round number dollar amounts are practical. There are no uniquely correct amounts. Rather the objective is to establish amounts that are within the range of what is appropriate. We have relied heavily on the extensive consultation process undertaken with the charity sector to determine what those amounts should be.

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<sup>6</sup> A similar problem will arise in relation to charities that are near the margins of being medium and large if a two tier assurance system is adopted (this is our preferred option – see section B1). It is impractical to move from review to audit and back again because financial statements include comparative information for the previous year. If a review was carried out the previous year, the auditor would need to re-check the information for that previous year in accordance with the higher positive assurance expectations of a reasonable assurance engagement.

<sup>7</sup> The same approach is used in the Financial Reporting Bill in relation to overseas companies, and by the XRB in its draft NFP accounting standards.

- 48 We tentatively proposed \$200,000 and \$300,000 in the April 2012 discussion paper. The consensus from submitters was that we had underestimated the costs of assurance and that \$200,000 and \$300,000 were far too low. Our concrete issues discussion paper, released in February 2013 proposed \$400,000 and \$1 million. There was broad support for those amounts in submissions.
- 49 Nevertheless, we have concluded that the lower amount should be \$500,000 rather than \$400,000. We were convinced by comments made in three submissions to the effect that an assurance engagement could represent too high a proportion of net profit for trading charities with expenditure of around \$400,000. For example, the gross profit of a trading charity with of that size might be \$100,000. After payment of any wages and other expenses, it might only have \$30,000 as a net profit for distribution to other charities. The cost of the audit would be a large proportion of that amount.
- 50 About 2,800 (11%) registered charities have total expenditure of \$500,000 or more. Of that total, about 1,600 (6%) have annual operating expenditure of \$1 million or more. Based on the studies carried out by Cordery & Patel (2011) and Cordery (2012), we estimate that about 80% of charities over \$500,000 are already obtaining assurance, which would mean that the proposals would require about 560 charities that are not currently obtaining assurance to do so.
- 51 We estimate the average cost would be about \$8,000 per charity per year, meaning a compliance cost increase of about \$4.5 million a year. The main assumptions underpinning the \$8,000 amount are as follows:
- a. The entities which are not having assurance carried out at present are predominantly medium-sized entities and "smaller" large entities.
  - b. Most of the extra assurance engagements will be carried out by mid-tier and small accounting firms.
  - c. The cost of assurance will increase once NZICA implements its Approved Auditor regime.
  - d. The extra audits and reviews will be carried out at commercial or subsidised rates, but not pro bono.
- 52 We have also estimated \$1 million a year in compliance costs for charities that are already having audits or reviews carried out, but will need to transfer from unqualified to qualified assurance providers. This is based on an assumption that 500 of those 2,200-odd charities are not using qualified accountants at present (again using the Cordery & Patel and the Cordery studies as the basis for that assumption) and they would pay an extra \$2,000 on average.
- 53 The total compliance costs will be about \$5.5 million a year.

*Alternatives to the \$1 million threshold*

- 54 Although most submitters agreed with the \$1 million amount to distinguish between medium and large charities, we also considered \$1.5 million and \$2 million as proposed by the Inter Church Working Party (ICWP) and the Association of NGOs of Aotearoa (ANGOA) respectively.

- 55 ICWP proposed \$1.5 million because a significant part of many charities' income is derived from cash donations. ICWP states that it is difficult if not impossible for an auditor to properly audit donations given that there may be no regular pattern, there are no goods and services provided in exchange and there is no invoice in advance. Accordingly, the audit report is likely to be qualified. ICWP states that this undermines the utility of the audit.
- 56 We disagree for the following reasons:
- a. A qualified opinion is wholly appropriate in these circumstances and provides useful information.
  - b. It is also useful for the auditor to state whether the reasonable assurance test has been met in relation to the remainder of the financial statements.
  - c. Even if it were a problem (which we do not accept), allowing the entity to obtain a review would not solve it. The entity will still receive a qualified opinion.
- 57 ANGOA stated that \$1 million feels like a reasonable level but added that it would be a lot simpler if the amount was to be \$2 million because it would be aligned with the amount set by the XRB to determine eligibility for Tier 3 reporting. ANGOA stated that they do not believe that there would be any significant difference in trust and confidence in the sector at this level.
- 58 We accept that alignment can have benefits, but it is a secondary consideration. The more important issue is that there is no connection between the costs and benefits associated with the Tier 2/Tier 3 preparation decision and the costs and benefits associated with the large/medium assurance decision. The preparation-related decision requires the XRB to weigh the reduced benefits to users against the lower costs of preparing in accordance with the Tier 3 simple format accounting standard rather than the more detailed Tier 2 accounting standards. The assurance-related decision requires a totally different trade-off: the lower assurance benefits against the usually lower costs of having a review rather than an audit carried out.
- 59 The Tier 2 accounting standards are much more complex and require considerably more disclosures, so the auditor will have more work to do for the Tier 2 entity than the Tier 3 entity. Therefore, the benefit/cost ratio of assurance is higher for Tier 3 entities just below the \$2 million than for Tier 2 entities just above \$2 million.
- 60 In addition, it is unlikely that the amounts would remain aligned. The preferred option for issue B4 (see paragraph 68) is to have an Order-in-Council making power to change the assurance numbers from time-to-time in accordance with movements in the Consumers Price Index (CPI). It is very likely that they would not remain aligned because:
- a. they are set by different people – Because the assurance amount changes would be made by Order-in-Council, it effectively means that the Government will do it. By contrast, the XRB carries out the analysis that leads to setting the tiers of reporting.
  - b. the criteria are different – The assurance amounts would be moved in accordance with movements in the CPI no less than eight years since the amounts were last set. The only flexibility for the Government is to round the amounts. By contrast, the XRB decides if and when the accounting tier criteria will be reviewed. The criteria in the Financial Reporting Act essentially require the XRB to carry out a subjective analysis of the advantages and disadvantages of different tier options.

*Alternatives to the \$500,000 threshold*

- 61 As noted above, we proposed \$400,000 in the 2013 discussion paper, but decided to recommend \$500,000 due comments made in three submissions about trading charities. Those submitters also stated that the purchase of goods for resale should be excluded from the calculation of operating expenses because the assurance engagement could represent a significant proportion of the surplus on the sale of the goods. We disagree. Excluding items from the relevant definition of operating expenses in accounting standards will add complexity. It will make it difficult for some entities to know whether they are small or medium, or medium or large and, therefore, what they have to do to comply with the law.
- 62 Two submitters proposed lower amounts (both proposed \$250,000) for increased accountability reasons. One stated that, as an auditor, he had seen many instances of financial discrepancies in charities and other NFPs. He stated that the discrepancy incidence is higher in the NFP sector due to the use of volunteers and underpaid staff, and poor controls and governance.
- 63 We acknowledge that there will continue to be a significant number of discrepancies where assurance is not carried out, but the costs associated with those discrepancies need to be weighed against the increased compliance costs associated with having more assurance engagements carried out. That has already been factored into our analysis. In addition, the proposal for DIA to monitor compliance with accounting standards is a cost-effective way of ameliorating some of the risks for charities with operating expenditure of less than \$500,000 (see part 2 of this RIS starting at paragraph 84).

**Issue B4: Whether to have a power to change the dollar amounts from time-to-time**

- 64 Dollar amount criteria in primary legislation often become outdated due to inflation. An extreme example is the maximum fine in the Incorporated Societies Act 1908 of 10 cents a day for operating a society without a registered office.
- 65 There are two issues:
- a. Whether there should be a mechanism for changing the amounts via secondary legislation
  - b. If so, how often the changes shall be made.
- 66 The choice on the first issue is reasonably straightforward. We consider that not having a mechanism to change the dollar amounts is not a serious option because:
- a. it would draw small charities into mandatory assurance where the benefits of doing so are exceeded by the costs
  - b. medium charities would move into the large category where review may be the more cost-effective assurance option.
- 67 All submitters who expressed views on this issue agree that there is a need for such a mechanism.
- 68 Turning to the second issue, both discussion papers proposed that the two dollar amounts for the criteria that determine whether a charity is small, medium or large should be changed by Order-in-Council no less than eight years since the amounts were last set. We continue to consider that eight years is appropriate because:

- a. Inflation has been low for the last 20 years. The average eight year compound increase in the CPI over that period has been about 20%. Requiring the amounts to be changed more frequently in times of low inflation is unnecessary.
- b. The eight year rule is a maximum. The Government would have the discretion to increase it earlier if inflation was higher.
- c. There are costs for the sector (e.g. changes to accounting systems) and the Government (e.g. the opportunity cost of ministers' time) every time the amount is changed.

69 Some submitters expressed alternative views on the details. The alternative proposals are discussed in Table 4.

**Table 4: Changing dollar amounts**

Option	Advantages	Disadvantages
Align the review frequency and method with the XRB's tier thresholds	Simplicity.	This would amount to giving an independent Crown entity the power to change an Act of Parliament. This should only be permitted if there is a very strong case.
Reduced maximum time, such as 3 or 5 years	A shorter time period may be appropriate during times of higher inflation.	- The preferred option takes high inflation periods into account because the 8 year rule is a maximum, not an actual. - The transition costs for some entities and the Government will be higher.
Adapt thresholds as and when needed, without a maximum time limit	A good option in principle.	Charities would lose the benefits of (i) certainty that the amounts will be changed from time-to-time, and (ii) predictability about the frequency of change.

**Issue B5: Assurance provider qualifications**

70 The objective in relation to this issue is to provide public confidence that those carrying out the assurance engagement have the competence to carry out the work to the required standard. This is important for two reasons. First, it promotes audit quality and, therefore, contributes to high quality reporting. Second, members of the public sometimes take the view that government regulation provides a guarantee that things will not go wrong. This is an unrealistic expectation because there is always regulatory error. However, setting an appropriate qualification standard reduces this moral hazard risk to an acceptable level.

71 We considered the following options:

- a. To require the engagements to be carried out by individuals and firms who are permitted to carry out company audits.
- b. As for Option (a), but include any member of a recognised professional accounting body, including members with retired status.
- c. A degree with an accounting major, or membership of NZICA or CPA Australia, and:
  - i. A qualification or experience relevant to NFPs (e.g. a Graduate Diploma in Not-For-Profit Management) or at least three years FTE direct experience in management, governance or financial administration of NFPs; or
  - ii. Current involvement in NFP management or governance, or able to demonstrate a NFP focus in continued professional development.

- 72 Option A was the preferred option in our two discussion papers and was supported by most submitters who commented on this issue. Option B was proposed by ICWP. Option C was proposed by Christchurch Community Accounting (CCA).

#### *Option A*

- 73 Option A is described in detail in paragraph 14(b) and footnotes 1 and 2. Option A recognises that an audit is not just about checking the numbers and confirming them against the financial records. Many of the issues that arise in an audit, particularly those involving valuations or assumptions about the future, involve estimates to which the auditor must bring their professional judgment. Consequently, assurance providers need:
- a. To understand accounting and assurance principles.
  - b. Knowledge of the applicable accounting standards and audit and assurance standards issued by the XRB.
  - c. The skills to identify the risks that could lead to a material misstatement in the specific circumstances of that engagement.
  - d. The knowledge to determine what audit evidence is needed and the analytical skills to evaluate the evidence.
  - e. The professional judgment to form an overall conclusion.
- 74 We prefer Option A for two main reasons. First, the specialised accounting skills and knowledge described above are essential to audit and assurance. Second, the audit requirements for companies are broadly applied to all statutory financial statement assurance other than Auditor Regulation Act and Public Audit Act audits. We do not consider that charity audits are a special case.

#### *Option B*

- 75 ICWP has proposed that the pool of eligible persons should include any member of NZICA or overseas equivalents. This would allow, for example, chartered accountants with retired status to undertake reviews of medium charities' financial statements. We disagree with this proposal because, as documented in the problem definition section, it is clear that many of the extra individuals (compared with Option A) do not have the knowledge, skills and experience identified in paragraph 73. There are also risks that retired members who met those requirements at the time they retired will not keep up with changes to accounting and assurance standards and other changes to assurance best practice.
- 76 ICWP also stated that an entity which is eligible to prepare in accordance with the XRB's Tier 3 NFP simple format standard (i.e. entities with operating expenditure of less than \$2 million) should not be required to have an assurance engagement completed if the financial statements have been prepared by a chartered accountant. We disagree with this proposal for two reasons:
- a. As noted in the problem definition section, there is evidence of poor knowledge of appropriate professional standards and generally accepted accounting practice by some accountants working in the charity sector.
  - b. Although a compilation engagement carried out by a public practitioner can significantly improve the quality of financial statements, it provides no assurance that financial statements have been prepared in accordance with GAAP. A compilation is limited to collecting, classifying and summarising financial information supplied by the entity and does not involve any verification of that information.

### *Option C*

- 77 CCA supported its proposal for using a different approach to auditor qualifications, as summarised in paragraph 71(c) above, by documenting several cases where chartered accountants incorrectly issued unmodified audit opinions that were corrected by CCA accountants, none of whom are chartered accountants. The problems mainly related to issuing unmodified opinions where the preparer had failed to distinguish between information prepared for tax and financial accounting purposes. For example CCA stated that unmodified audit opinions had been issued where the entity had grossly understated values for land and buildings, and expensed asset purchases below \$500 without explaining this policy in the notes to the financial statements. CCA also described unsatisfactory preparation practices by chartered accountants in relation to the accounting treatment of grants and advance-paid government contracts.
- 78 CCA's comments are consistent with information obtained from other sources. However, its proposal does not address the problem because it would not exclude chartered accountants who do not have the necessary skills, knowledge and experience to carry out assurance engagements. Our view is that NZICA's proposal to introduce an Approved Auditor status designation has the potential to address this problem, although how effective it will be will not become clear until more details about the scheme become available.
- 79 In addition, we consider that CCA's proposal is unworkable. We do not see how the public could have confidence in what would effectively be a new class of assurance practitioner unless there was regulatory oversight, including transparent entry and on-going competence requirements, and complaints, investigation and disciplinary processes. It is likely that such a system would have high fixed costs per practitioner, given the limited market for NFP financial statement assurance.

### *Licensed auditors*

- 80 We did not consider the possibility of limiting medium and large charity assurance to individuals and firms licensed under the Auditor Regulation Act 2011. That Act is designed to regulate audits of financial sector entities and entities that participate in public capital markets. It would be disproportionate to limit charity assurance to auditors and audit firms licensed and registered under that Act.

### **Conclusions**

- 81 Assurance carried out in accordance with audit and assurance standards is an indispensable element of high quality financial reporting because it provides an independent evaluation of whether financial statements comply with applicable accounting standards. This, in turn, provides users of the financial statements with greater confidence that the financial statements can be relied upon for accountability and decision-making purposes.
- 82 The regulatory impact analysis carried out above demonstrates that mandatory independent assurance carried out by qualified accountants is of net benefit for very large charities and net cost for very small charities. The aim was to find an appropriate point somewhere between very large and very small where the marginal benefits exceed the marginal costs. Because the benefits cannot be reliably quantified, we have relied on extensive sector consultation to get a sound conceptual understanding. We are satisfied that the advantages outweigh the disadvantages by having a two-tier system with criteria of \$500,000 and \$1 million operating expenses and a requirement for the assurance to be carried out by qualified accountants.
- 83 The costs and benefits are summarised in Table 5.



**Table 5: Summary of costs and benefits**

Party	Benefits	Costs
The charity sector & charity beneficiaries	Maintains and grows the sector due to the reputational benefits and positive signals to the donating public.	Compliance costs estimated at \$5.5 million a year which reduces the amount spent on charitable purposes.
Donors	Higher levels of accountability to donors, who donate about \$1 billion a year to registered charities.	
The Government & taxpayers	- Improves accountability for the forgone income tax revenue of \$350-\$400 million a year. - Contributes to Inland Revenue's monitoring and investigation activities.	

## Part two – Regulatory impact analysis for monitoring compliance with accounting standards

### The status quo

- 84 DIA monitors annual returns to check whether the entity remains eligible for registration. The monitoring does not include checking the financial statements because there are no applicable accounting standards. However, that situation will change. Subject to the timing of the enactment of the Financial Reporting Bill, the XRB plans to bring NFP accounting standards that will apply to registered charities into force for financial years beginning on or after 1 April 2015. The first financial statements that will be required to be prepared in accordance with the NFP standards will be lodged with DIA in the third quarter of 2016.
- 85 In addition, the Charities Act provides for group registration of entities that are affiliated or closely related, subject to the terms and conditions imposed by the Charities Board or DIA. The Financial Reporting Bill adds new provisions which will require terms and conditions relating to financial reporting by groups to be set.

### Problem definition

- 86 Fewer entities are likely to comply with the law if there are no adverse consequences for non-compliance and it is widely known that there are no consequences. Assurance, particularly audit, manages most of that risk in relation to large and medium charities. However, it does not deal with the risk in relation to small charities that do not have an assurance engagement carried out by a qualified accountant.

### Objectives

- 87 The objective for part two of the RIS is to establish a cost-effective means of promoting compliance with accounting standards and the related terms and conditions for group registrations, particularly in relation to charities that do not have an assurance engagement carried out by a qualified accountant.

## Regulatory impact analysis for monitoring compliance

### The Options

88 The options we considered are to have compliance monitoring or to not have compliance monitoring.

### Evaluation of options

89 The February 2013 discussion paper proposed that DIA would monitor compliance with the NFP accounting standards using a risk-based approach to determine which returns would be checked. It is intended to be a low-cost alternative to requiring independent assurance for small charities. Therefore, there is a relationship between the dollar thresholds for mandatory audit and assurance, and the total costs of the compliance monitoring activity. If higher dollar thresholds were to be used to define medium and large charities, then it would be important to increase the amount of monitoring activity.

90 The main benefit would be to contribute to improving the quality of reporting and maintaining public confidence in charity. Repeated non-compliance could lead to the entity being deregistered, meaning that it would lose the income tax exemption that is obtained through registration and the reputation benefits associated with being a registered charity. The threat of deregistration will provide quite a strong incentive to comply as long as there is a significant risk that non-compliance will be detected. In the worst cases, DIA might also detect possible accounting fraud, in which case it could draw the matter to the attention of the Police.

91 The cost of accounting standards compliance monitoring activity will depend on the details of the monitoring system. There is insufficient information at present to assess the costs and benefits because the scope and nature of monitoring is yet to be determined. Under the proposals in the Cabinet paper related to this RIS, the Minister for the Community and Voluntary Sector will report to Cabinet by 31 March 2015 on these matters. Therefore, DIA will analyse these issues.

92 The only proposition we are making at present is that a cost-effective risk-based monitoring scheme will be better than no monitoring at all. Eight of the nine submissions that commented on the monitoring proposal agreed, although some concerns were expressed about funding it through a levy on charities. It is yet to be determined how the monitoring activity will be funded.<sup>8</sup>

93 ICWP disagreed with the monitoring proposal for the reasons outlined in Table 5.

**Table 5: ICWP's submission on monitoring by DIA**

ICWP's submission	MBIE's view
Monitoring is not needed if the financial statements have been assured by a qualified accountant.	We agree that the risks are much lower in these circumstances. However, assurance does not preclude the possibility of non-compliance because (a) it does not provide absolute assurance that the financial statements comply with GAAP, and (b) assurance providers sometimes make mistakes.
No investigation should be required, unless a complaint is laid against a charity.	Complaints are a useful source of information. However, this is no reason to limit the regulator's investigatory discretion.

<sup>8</sup> The options comprise an adjustment of baselines, reprioritisation of funding, a levy on registered charities, or a combination of approaches. DIA will analyse these options.

## Conclusions – DIA monitoring

- 94 The only proposition we have sought to establish is that some monitoring is better than none. We have concluded that this is the case because the incentives to comply with the standards will be much lower if it is known by preparers that non-compliance is unlikely to have adverse consequences, notably deregistration.
- 95 The more thorough analysis to determine the scope and nature of the monitoring and how it will be funded will be carried out by DIA. Cabinet decisions will be sought by 31 March 2015.

## Consultation

- 96 Two discussion documents were issued and there were oral public consultation processes while both papers were open for comment.

### The first discussion paper

- 97 The first discussion paper, *Auditing and Assurance for Larger Registered Charities* was released in April 2012 and was open for three months. It proposed:
- a. Requiring large charities to have their financial statements audited by qualified accountants. A charity will be large if its operating expenditure was \$300,000 or more for both of the last two financial years.
  - b. Requiring medium charities to have their financial statements reviewed or audited by qualified accountants. A charity will be medium if it is not large and its operating expenditure was \$200,000 or more for both of the last two financial years.
- 98 58 submissions were made: 23 by accounting practices, 27 by registered charities, four by individuals, two by professional accounting bodies and two by academics. We worked alongside the Association of NGOs of Aotearoa (ANGOA) to carry out workshops in five centres while the discussion paper was open for comment. Just over 200 people attended.
- 99 Most respondents noted the importance of public confidence to the maintenance and growth of the charitable sector. It was also noted that it was crucial to ensure that the public confidence benefits of assurance outweigh the financial costs of undertaking an assurance engagement. Most submitters stated that this was not achieved at the \$200,000 and \$300,000 levels and proposed significant increases.
- 100 Some respondents:
- a. Stated that the requirements should only apply to charities which receive funds from the public through donations.
  - b. Expressed concerns about the availability of suitably qualified persons, particularly in rural areas.

## **The second discussion paper**

- 101 The second discussion paper, *Auditing and Assurance for Large & Medium Registered Charities – Concrete Proposals* was released in February 2013 and was also open for comment for three months. During that time, there was a seminar series involving the XRB, ANGOA, DIA and MBIE. 23 seminars were held in 15 locations around New Zealand and about 2,000 people from a wide range of organisations attended. The focus was on the draft simple format reporting standards for NFPs that were exposed for comment by the XRB from December 2012 to June 2013. Presentations were also made on the MBIE discussion paper.
- 102 27 submissions were made: nine by accounting firms, eight by registered charities, three by individuals, two by iwi groups, two by professional accounting bodies, two by other professional bodies and one by an academic.
- 103 There was broad consensus on the need for compulsory assurance for large and medium registered charities, and all respondents were in support of annual operating expenditure as the measure for ascertaining the thresholds for such charities. There was also broad support for limiting assurance engagements to qualified accountants and for DIA to monitor compliance with applicable accounting standards.
- 104 As noted above, the main difference between the two papers was to substantially increase the thresholds for mandatory assurance, thereby reducing the number of charities affected by the proposals. Most respondents agreed that the threshold for large registered charities should be set at \$1 million OPEX over two consecutive years although, as noted earlier, \$1.5 million and \$2 million were also proposed.
- 105 A majority of submitters who commented on this matter agreed that the lower threshold should be set at \$400,000 OPEX. However, some respondents alternatively proposed \$250,000, \$500,000 and \$600,000. We changed our preference from \$400,000 to \$500,000 after taking those submissions into consideration.
- 106 There was strong support for the two consecutive year test and on the requirement for a mechanism to review the thresholds based on movements in the CPI. However there were mixed views on the period of review, with several respondents stating that the minimum period for CPI-related movements should be less than the 8 years proposed in the discussion paper.
- 107 Most respondents agreed that there should be no legislative requirement to have non-assurance engagements completed and that there should be no exemption making powers. A small number of respondents considered that charities which are wholly privately funded should be exempt from any assurance requirement because they have no donors to whom they are accountable.

## **ANGOA's role in the consultation processes**

- 108 The NFP sector is diverse and atomised and it can be challenging to communicate effectively with it. ANGOA is uniquely placed to facilitate such communication because it is the only NFP umbrella organisation whose membership is made up of diverse NFP subsector umbrella organisations.
- 109 ANGOA has been tremendously helpful during this process. It organised the workshops in 2012, facilitated the seminar series in 2013, publicised our discussion papers, increased NFP sector awareness about the issues, promoted informed comment, and channelled some of the feedback from the sector. Overall, ANGOA has made a really big difference.

## **Implementation**

- 110 Amendments to the Charities Act will be needed to give effect to the changes. The intention is to include the changes in the Accounting Infrastructure Reform Bill, which is expected to be introduced later in 2013, with a view to enactment in 2014. No regulations be needed. The aim is to bring the requirements into force at the same time as the NFP accounting standards, i.e. for financial years starting on or after 1 April 2015.
- 111 We do not consider that there are any significant implementation risks. Although it will be desirable to make the assurance changes at the same time the accounting standards come into force, it is unlikely to create any major implementation problems if the assurance requirements were to be delayed by up to a year. In addition, the changes to the Charities Act will be short and simple, so the risks of unintended consequences due to mistakes in the law are low.
- 112 Ideally, monitoring will be brought into force in the third quarter of 2016 because this is when the first financial statements prepared in accordance with accounting standards issued by the XRB will be lodged with DIA.

## **Monitoring, Evaluation and Review**

- 113 The assurance changes will not come into force until 2015. Subject to approval by the Minister of the day, we intend to carry out a before-and-after comparison of the quality of financial reporting insofar as it relates to the introduction of the audit and assurance requirements.
- 114 The first review of the dollar amounts that determine whether a registered charity is small, medium or large will take place no later than 2023. We will monitor whether changes should be made earlier via stakeholder engagement. We will also coordinate with the XRB in relation to any plans it may have to review the Tier 2/Tier 3 dollar criterion and, if so, determine whether the assurance amounts should be changed at the same time.
- 115 The need to monitor, evaluate and review DIA monitoring will be considered by DIA before the Minister for the Community and Voluntary Sector reports to Cabinet in 2015.



## Appendix One: Definitions

**Assurance** refers to an engagement in which an assurance practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. Put more simply, assurance enhances users' confidence in the financial information that is being reported.

The objective of a **reasonable assurance engagement** is a reduction in assurance engagement risk to an acceptably low level as the basis for a positive form of expression of the assurance practitioner's opinion.

An **audit** of general purpose financial statements is a reasonable assurance engagement in which an assurance practitioner expresses an opinion whether financial statements are prepared in accordance with generally accepted accounting practice (GAAP) in all material respects. An audit of general purpose financial statements is carried out in accordance with International Standards on Auditing (New Zealand) and involves detailed testing, evidence gathering and substantiation to support the conclusion.

An **unmodified audit opinion** provides reasonable assurance that the financial statements as a whole are free from material misstatement, whether due to fraud or error. A **modified audit opinion** (i.e. a qualified opinion, adverse opinion or a disclaimer of opinion) is issued if the auditor disagrees with management about the financial statements or if he or she is unable to obtain sufficient appropriate evidence to support an unmodified opinion.

The objective of a **limited assurance engagement** is compliance reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than that for a reasonable assurance engagement, as the basis for a negative form of expression of the assurance practitioner's opinion.

A **review** of general purpose financial statements is a limited assurance engagement conducted in accordance with Review Standard 1 (RS 1), in which the assurance practitioner expresses a conclusion on whether anything that has come to the assurance practitioner's attention that causes the assurance practitioner to believe that the financial statements have not been prepared, in all respects in accordance with GAAP. A review primarily consists of making enquiries and applying analytical procedures. A review may bring significant matters affecting the financial statements to the assurance practitioner's attention, but the procedures are less detailed and a review does not provide all of the evidence that is required in an audit.

The assurance practitioner has the same range of opinion options for a review as outlined above for an audit, except that the conclusion is expressed in negative terms.

**Independence** adds credibility and is an essential part of the audit process. In auditing this encompasses:

- Independence of mind – the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional scepticism.
- Independence in appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the facts and circumstances, that a firm's, or a member of the audit and assurance's team's integrity, objectivity or professional scepticism has been compromised.<sup>9</sup>

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<sup>9</sup> XRB, Explanatory Guide Au4 *Glossary of Terms*, March 2013; CPA Australia, *A guide to understanding auditing and assurance*, February 2013; Australian Department of Finance and Deregulation, Finance Circular No. 2011/08, *Clarification of the terms Audit and Assurance*, 2011; and PwC, *Understanding a financial statement audit*, January 2013.





## Appendix Two: Random sample of \$10 million-plus charities

Random number	Charity	Year	Auditor	Notes
138	Auckland UniServices Ltd	31/12/11	Ernst & Young	
51	Nurse Maude Association	30/06/12	PwC	
219	Trinity Lands Ltd	31/05/12	Auditors on London	
86	Roman Catholic Diocese of Christchurch Diocesan Trust	30/06/12	Ernst & Young	
82	Medical Council of New Zealand	30/06/12	PKF Martin Jarvie	
207	National Assistance Fund	30/06/12	None	1
153	King's School, Auckland	31/12/11	BDO	
115	Midlands Health Network Ltd	30/06/12	KPMG	
22	Alliance Health Plus Trust	30/06/12	Stowers Audit	
116	Hohepa Homes Trust Board	30/06/12	PwC	
3	National Heart Foundation of New Zealand	30/06/12	KPMG	2
210	Waikato Raupatu Lands Trust	31/03/12	PwC	
12	St George's Hospital Group	31/03/12	Ernst & Young	
165	Auckland PHO Ltd	30/06/12	Hayes Knight Audit	
53	New Zealand Housing Foundation	31/03/12	Gilligan & Co	
162	Saint John's College Trust Board	31/12/11	Deloitte	
170	Rangi Ruru Girls' School Board of Governors Inc	31/12/11	PwC	
130	Waikato Anglican College Trust	31/12/11	Deloitte	
34	Iris Ltd	30/06/12	Grant Thornton NZ Audit Partnership	3
121	Presbyterian Support Services (South Canterbury) Inc	30/06/12	Martin Wakefield	
126	Te Taiwhenua o Heretaunga Trust	30/06/12	BDO	
118	Waikato Primary Health Ltd	30/06/10	KPMG	4

### Notes

1. The National Assistance Fund facilitates the provision of schools and other educational facilities operated on Christian principles or principles similar to those of the Christian faith. The total expenditure of \$27,055,151 comprised two amounts: administration expenses of \$386,587 and grants of \$26,668,564. The financial statements were prepared by BMS Accountants Ltd under a compilation engagement. There was no independent assurance.
2. The National Heart Foundation has two subsidiaries: the Trust for the Chair of Cardiovascular Studies and the Heart Health Research Trust. They are registered as three separate entities under the Charities Act. There are no financial statements, either consolidated or for any of the three entities for the 2011/12 year on the register. The information appearing in the table above was obtained from the consolidated financial statements for 2011/12 appearing on the Foundation's website. The definition of "control" in accounting standards issued by the XRB means that the reporting entity is the group. Therefore, the audit report on the Foundation website relates to the Foundation and the group, comprising the Foundation and its two subsidiaries. There are entity (not consolidated) financial statements for the Foundation on the register for 2010/11, but no audit report.
3. Iris Limited's annual report states that Grant Thornton is the auditor. However, the audit report was redacted from the financial statements lodged for the year ended 30 June 2012.
4. Waikato Primary Health Ltd was removed from the Charities Register on 17 May 2012 for failing to submit an annual return for the year ended 30 June 2011.



## Consultation on Cabinet and Cabinet Committee Submissions

### Certification by Department

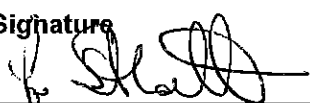
**Departments/agencies consulted:** The attached submission has implications for the following departments and agencies whose views have been sought and are accurately reflected in the submission:

Department of Internal Affairs, Inland Revenue Department, Treasury, External Reporting Board and Office of the Auditor General

**Departments informed:** In addition, the following departments have an interest in the submission and have been informed:

Department of the Prime Minister and Cabinet

**Others consulted:** Other interested groups have been consulted as follows: None

Signature	Name, Title, Department	Date
	Iain Southall, Manager Corporate Law, MBIE	27/06/2013

### Certification by Minister

Ministers should be prepared to update and amplify the advice below when the submission is discussed at Cabinet or a Cabinet committee. The attached proposal:

<i>Consultation at Ministerial level</i>	<input type="checkbox"/> has been the subject of consultation with the Minister of Finance <i>[required for all submissions seeking new funding]</i> <input checked="" type="checkbox"/> has been the subject of consultation with the following portfolio Minister(s) ..... <i>Coastal, Treasury</i> <input checked="" type="checkbox"/> did not need consultation with other Ministers	
<i>Consultation with National caucus</i>	<input checked="" type="checkbox"/> does not need consultation with the government caucuses <input type="checkbox"/> has been or <input type="checkbox"/> will be discussed with the government caucus <input type="checkbox"/> does not need discussion with the government caucus	
<i>Discussion with other parties</i>	<input type="checkbox"/> has been discussed with the following other parties represented in Parliament: <input type="checkbox"/> Act Party <input type="checkbox"/> Maori Party <input type="checkbox"/> United Future Party <input type="checkbox"/> Other [specify] <input type="checkbox"/> will be discussed with the following other parties represented in Parliament: <input type="checkbox"/> Act Party <input type="checkbox"/> Maori Party <input type="checkbox"/> United Future Party <input type="checkbox"/> Other [specify] <input checked="" type="checkbox"/> does not need discussion with other parties represented in Parliament	
<b>Portfolio</b>	<b>Date</b>	<b>Signature</b>
<i>Counsellor</i>	<i>30/6/13</i>	