INTER CHURCH
WORKING PARTY

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20 July 2012

Assurance for Larger Registered Charities
Competition, Trade and Investment Branch
Ministry of Economic Development
PO Box 1473
WELLINGTON

Dear Sir/Madam

RE: SUBMISSIONS BY THE CHURCHES IN RESPONSE TO DISCUSSION PAPER AUDITING AND ASSURANCE FOR LARGER REGISTERED CHARITIES

We attach hereto our Submission in relation to the above named Paper.

If there are hearings we wish to speak in support of this Submission.

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Please mark any correspondence "(Attention Mrs Gillian Robertson)".

Yours faithfully

G. B. H. Robertson

(Mrs) Gillian B H Robertson
Chairperson
INTER CHURCH WORKING PARTY

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For: **Competition, Trade and Investment Branch**
Ministry of Business, Administration and Employment
WELLINGTON

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Submissions by the Churches in Response to Discussion Paper Auditing and Assurance for Larger Registered Charities

O. Overview

O.1 This submission is made on behalf of almost all of the Christian Churches in New Zealand (**"the Churches**") and their related social services agencies. A detailed list of the Churches is set out in the Appendix.

O.2 The Churches are concerned at the costs the current proposals are likely to impose for little or no benefit to them or to donors.

O.3 In particular, the Churches **do** already report to their supporters in a form and in a manner designed to inform and to be accountable to those supporters. These supporters are not seeking a higher level of assurance than they already receive.

O.4 The Churches are, perhaps, in a somewhat unique position compared with other charities in that, leaving aside their social agencies and schools, most of their income is by way of donations from those who attend weekly at the local level. Any reporting (and assurance) needs to be geared to these users.

O.5 Such users have a good knowledge of the activities of the local church and wish to support that local Church. They do **not** want highly sophisticated audited accounts nor do they want their donations being spent on such accounts rather than the core work of the Church. Indeed, such accounts may be beyond their ability to fully understand.

O.6 Making the matter more complicated is that the activities of a Church often are undertaken through different entities (both incorporated and unincorporated) each producing their own set of accounts. A major concern arising out of the current proposals is that consolidation may be required which not only adds to the expense (including because it takes the Church into the next tier) but actually makes the accounts **less** meaningful for the user/supporter.

O.7 Paragraph 4 of the Discussion Paper asserts that it "*is equally clear that the benefits of assurance outweigh the costs for the largest 4% of the registered charities…The challenge is to establish a dollar threshold…that would determine whether a charity is large enough to justify adding an assurance obligation*".

O.8 The Churches thoroughly endorse the underlying concept that the compliance costs should not be imposed unless the benefit **to the charity** (as opposed to third parties with no financial or other direct interest in the charity) outweighs the cost. Unfortunately no analysis appears to have been undertaken to assess the benefit of what is proposed. We stress "benefit to the charity" because, if it is the external benefit of an audit that is relevant, then, on that logic and using the figures in the Discussion Paper, it should be required of any business with operating expenses of $300,000 or more for the same reasons as are given at para 11 of the Discussion Paper. A business provides benefit to the overall economy and to tax revenues.

O.9 The Churches are concerned at the heavy reliance on the Cordery and Patel report and Rowena Sinclair's thesis. The data they appear to have reviewed is very limited with a wide margin for error. Moreover a number of charities, and the Churches in particular, have used the "single entity" regime in s44 of the Charities Act for registration purposes. The test under that section is different from that imposed when considering whether or not consolidation is required. Single entity registration is available even where consolidation is not required. There will be many more churches who will be affected by the current proposal than at first appears because their registration is under the umbrella of a wider organisation. That will lead to greater cost and also greater demand for auditors and reviewers which will push the cost up even further.

O.10 Against that background we turn to the individual questions.

1. Question 1

Q1. Do you have any comments on the description of the problem definition?

1.1 It is not entirely clear what "*problem definition*" this question seeks comment on. Is it:

(a) A failure to apply GAAP;

(b) A failure to keep up with GAAP;

(c) False accounting as described in para 15 (which may be a crime);

(d) Charities needing better opportunities to tell their story;

(e) Better compliance with GAAP is required to enable those concerned with a charity's governance to manage the charity's resources efficiently and effectively?

1.2 The Churches do not condone false accounting. However it is by no means clear that requiring a level of assurance for accounts will necessarily prevent the examples described in para 15. As can be seen over many decades in the "for profit" sector, having accounts audited does not necessarily decrease "false accounting" nor does it reduce the possibility of failure. Audits are also not an efficient way of detecting fraud. It was for this reason that, many years ago, the audit of lawyers' trust accounts was abandoned.

1.3 The Churches do **not** accept that assurance obligations will necessarily enable those involved in a charity's governance to manage its resources better, especially when the associated cost imposition is taken into account. Good governance and assurance obligations are two separate disciplines with assurance having only a small role in good governance. Arguably, management accounts have a greater bearing upon good governance than annual accounts, with or without assurance. For most local churches most of their financial resources are committed well in advance to meeting basic day to day costs such as salaries, building costs (rates, maintenance etc) and levies to the central church organisation. Discretionary spending is somewhat limited. Requiring a higher level of assurance, even if it leads to better accounts, will have no impact on spending decisions as many of the expenses incurred are fixed. Further, accounts that have been reviewed or audited look backwards, spending decisions look forward.

1.4 Nor will requiring review or audit lead to better telling by the charity of its story.

1.5 Moreover the question assumes that non-compliance with GAAP is a problem. In fact, as the move to accounting standards specifically tailored to "not for profits" highlights, GAAP is part of the problem.

1.6 In particular, strict compliance with the latest GAAP is not necessarily essential for smaller church bodies where the prime users of accounts, the local parishioners, are very aware of the activities of the parish on a week by week basis. Their ongoing support arises because they are in sympathy with those activities. When they cease to be in sympathy they either leave or stop giving. These decisions are unlikely to be influenced by the state of the accounts. There is a danger that the idealistic views of highly qualified academics may be at odds with the needs and requirements of the prime users of the accounts, the parishioners. The Discussion Paper does not provide any evidence that supporters of registered charities (including supporters of "large charities") require more compliance by way of further assurance work than they currently receive.

1.7 It is important to recognise that there are fundamental differences between a registered charity and a business. The success of a business is measured in financial terms. An audit is, or can be, an important check on the financial measuring rods used by the business. A business also pays tax. An audit can assist in getting the tax obligations correct. A charity, on the other hand, measures its success in terms of the beneficial impact it has on the community it serves (which impact will not be easily measured by objective standards). Also a charity does not pay tax.

1.8 There is, accordingly, much less need for and benefit from an audit for charities than for business. Yet there is no suggestion of compulsorily requiring audits of equivalent sized businesses.

2. Question 2

Q2 Do you have any comments on the description of the objective?

2.1 The Churches accept that there is a need for an appropriate balance between the benefit associated with increased quality and reliability of financial statements, if they have been assured, and the additional costs associated with the assurance engagement. The first problem is defining or measuring the "*benefit*", and the second problem is getting the balance right. Neither occurs in the Discussion Paper. There is also an assumption that audit assurance is the only means of achieving the objective when it is not.

2.2 It is implicit from para 17 that the benefit is primarily for potential funders and donors, both in terms of deciding to support the charity and in providing information that the public funds are being used effectively and efficiently. This, in turn, is thought to promote public confidence and trust which, presumably, leads to further funds. However, although that sounds good in theory, in practice it is not so simple.

2.3 There does not appear to be any research reported within the Discussion Paper on what users of financial information provided by charities want and need, either to ensure that the governance mandates given to the governing body are being complied with or before they donate further funds.

2.4 Based on the experiences of the Churches we do not consider that having a set of audited or reviewed annual accounts that meet some externally imposed standard, especially an international standard developed for commercial enterprises, is the primary or even a material reason why a donation or grant is made.

2.5 In broad terms there are 3 categories of funders:

(a) The first group are those who make significant grants, such as the Government. Here the grantor can stipulate the level of accountability. It is inappropriate to impose assurance standards which grantors of funds want, across all charities, even on those who do not seek such grants. Moreover, if better accounts (including assurance) are likely to attract more funds, the incentive is there any way without the necessity of compulsion. Individual charities are best placed to make that assessment.

(b) The second group are those who pay for the service they use, such as parents of pupils at private but charitable, educational institutions, patients at private hospitals, Southern Cross insurance subscribers etc. Their interest is whether they get value for money. There is no evidence that such users require audited accounts;

(c) Instead, when laying down mandatory requirements, the focus should be on those who make donations (rather than grants). Such persons are not likely to be sophisticated readers of financial statements. Nor are they likely to be interested in lengthy documents with long and dense notes driven by the demands of auditors. Their prime motive for giving will be empathy with the work of the charity. For the vast majority of donors, this is likely to be little affected by the accounts of the charity.

2.6 Whatever may be wanted by donors, the one certainty is that they will not want their donations to be diverted from the proper purposes of the charity in order to meet excessive or unwarranted compliance costs.

2.7 In many respects donors are like consumers purchasing goods or services. They part with their money because of their knowledge of and experience with the product being offered. Most consumers do not want the financial statements of the providers. So too, most donors give because they support and like the "product" being offered by the charity to those the charity serves. Donors give to a City Mission because they see it helping the less privileged. They give to World Vision because they see it meeting needs in the Third World. Like consumers, donors do not want the financial statements of the charity, and certainly do not want a lot of resources being consumed in obtaining assurance for such accounts instead of advancing the work of the charity.

2.8 There is then the problem that, for most charities that rely on donations, their accounts will be qualified (see below at paras 8.8 and 8.9). There may also be qualifications to the audit report because of valuation issues around fixed assets (see para 8.10 below). How then does such qualified audit create greater confidence leading to more funds or better choices between charities?

3. Question 3

Q3 Do you have any comments on the description of the options?

3.1 We agree that there are 4 options (in ascending order):

(a) No outside assurance;

(b) Review by way of independent examination;

(c) Review by a chartered accountant;

(d) Audit.

3.2 There should be a tiered approach reflecting those options.

4. Question 4

Q4 Do you consider that large charities should be required by legislation to have an assurance engagement completed?

4.1 The Churches do not have a problem with the requirement that **truly large** charities should be required to have an assurance engagement completed.

4.2 Our concern is with the definition of "large" – see para 8.2.

5. Question 5

Q5 Assuming that mandatory assurance was to be introduced for large registered charities, do you consider that (a) all large registered charities should be required to have an audit completed or (b) that 'less large' charities should be required to have an audit or a review completed and more large charities should be required to have an audit completed?

5.1 The Churches consider that only the truly large charities should be required to have an audit and that "less large" charities should have the option of a review.

5.2 The Churches do not rule out the possibility of allowing less large charities having an "examination". Whether this is viable depends on 2 issues:

(a) The cut off levels for the various requirements;

(b) The qualifications required for an auditor/reviewer.

5.3 If the threshold levels are low then there is a real need for independent examiners. So too, if the qualification requirements for an auditor or reviewer are too stringent. At present the majority of local parish churches rely on voluntary reviewers or auditors who may be qualified accountants (that is, a member of the Institute of Chartered

Accountants rather than a licensed auditor), often experienced in producing accounts for audit (i.e. from the consumer perspective) and, so, with a good understanding of the sorts of checks required. This should be all that is needed at the level of smaller charities.

6. Question 6

Q6 Which measure or measures should be used for determining whether assurance is required and, if there are to be tiers, for setting the cut-off point between audit and review?

6.1 The Churches agree that annual operating expenditure is the appropriate measure.

6.2 "Operating expenses" should be defined in relation to cash expenditure on what is needed to operate the charity. That is, it should exclude:

(a) Depreciation. A parish with a valuable building may have significant depreciation expense, especially if the building is valued based on best, but alternative, use. In this event the non-cash item depreciation could be as high as 40% of "expenditure". Yet the parish could still be very small;

(b) Grants by philanthropic trusts. These are distributions, not operating expenses and philanthropic trusts, particularly private ones, should not be put to the expense of an audit if they do not want it.

6.3 If a different and wider definition of "operating expense" is used then the thresholds have to be higher.

6.4 The Churches would be particularly against the use of total assets. This is because, as is identified at para 43, most of the assets of the churches are not used for economic purposes. Indeed, especially if they have a Category 1 or Category 2 registration under the Historic Places Act, they are more of a liability than an asset and certainly not worth the nominal book value or valuation by Valuation New Zealand.

6.5 Whatever measure and threshold is adopted there needs to be a buffer zone. Suppose annual operating expenditure is used with a $2m threshold between audit and reviews. A charity and its reviewer may begin the end of year exercise thinking the charity is under the threshold. But, well into the review with the deadline for filing imminent, it is discovered that 1 of the accrual accounting calculations is wrong, or the cost of the review has been under estimated thereby pushing the charity over the threshold. If the exercise has to be recommenced the cost will be disproportionately high for the minimal extra benefit of an audit.

7. Question 7

Q7 Do you prefer Option A, Option B (see paragraph 49) or another option in relation to assurers' qualifications?

7.1 The Churches can live with Option B **provided** the thresholds for audit or review are suitably high. At the moment they are **not**.

7.2 This is also **provided** that the restrictions on who can be an auditor are:

(a) no more restrictive than the current s199 of the Companies Act; and

(b) extend to include retired members of the New Zealand Institute of Chartered Accountants provided they do **not** charge.

7.3 Many charities are able to procure the services of voluntary auditors. The statutory requirements should not be such as to discourage such volunteers.

7.4 The Churches are very much opposed to restricting auditors and reviewers to those who are licensed auditors.

8. Question 8

Q8 What are your views on the tentative proposal for all registered charities with annual operating expenditure of $300,000 or more to have an audit completed and annual operating expenditure of $200,000-$300,000 to have a review or an audit completed?

8.1 The proposed thresholds are way too low.

8.2 The Churches propose above **$500,000** of operating expenses **for review** and above **$2m for audit**. They note that the $2m threshold is similar to the threshold for the need for compliance with (reduced) disclosure requirements based on IPSAS. There is merit in having the same threshold so that charities address both issues at the same time.

8.3 The Churches consider that it is unreasonable to impose involuntary audit or review costs on 20% of charities (the number given in para 63a) (a percentage far higher than would be the case for companies). There is no analysis of whether costs are matched by any resulting benefit, merely an assertion that it is assumed there would be obtained $1 or more benefit for every $110 of operating expenditure. How that assumed benefit arises is not clear.

8.4 At least in the case of individual church units they can reach the $300,000 proposed audit threshold very quickly if they employ four full time equivalents, as well as meeting property expenses and levies to fund the national or regional body. There would be very little truly discretionary spending.

8.5 The Churches dispute that the costs of audit or review will be as little as shown in para 58. These figures look only at estimates from providers which, no doubt, assume that the relevant charity is local and may reflect that the client is a charity.

8.6 In particular:

(a) No provision appears to have been made for the internal cost to the charity, both preparing for the audit and working with the auditor;

(b) The cost referred to in (a) is incurred by all entities being audited. However, given the rather unusual nature of charities, it is a common experience of those who are audited already that they have to spend time each year educating the auditors about their particular entities. Standard accounting firm practice is to send in juniors who change year by year and who do not understand the entity they are being asked to audit;

(c) Many charities are not located in centres that would have accounting firms with the personnel able to conduct the audit. This will lead to costs of travel being in addition to those quoted;

(d) If the threshold is set too low there will be a significant number of charities seeking audits (more than estimated in the Discussion Paper for the reasons in Overview para O.9 above). The resulting demand will push the cost up on the ordinary rules of supply and demand, compounded by the degree to which the estimates given include some concession for the entity being a charity. There are only so many charitable entities to which any one firm would wish to give a fee concession;

(e) Because charities are not like commercial enterprises for whom most accounting rules have been devised, there will be complex accounting questions including as to the interrelationship between a charitable entity and associated entities. This is particularly so for churches which have overarching national or regional organisations for doctrinal and discipline reasons with some centralisation. But unlike in the commercial model, the overarching body is there to service the local level and is accountable to the local level, not vice versa;

(f) There is a tendency for audit firms, having captured the work, to significantly push up the cost in subsequent years.

8.7 Those factors will be magnified if either or both of the following rumoured changes occur:

(a) Auditors have to be licensed;

(b) The time for lodging financial reports is shortened.

Such moves will increase the power of auditors to increase charges.

8.8 Moreover, there is one area where an audit of a charity is not straightforward leading to a real question as to the utility of an audit at the proposed levels. This relates to donations.

(a) Donations are often in cash – more so than for most business transactions;

(b) Unlike businesses, individual donations are not matched by a prior invoice or the handing over of goods;

(c) Donations can be highly variable from year to year. The auditor cannot rely on past performance as a good indicator of the reasonableness of the donations for the current year.

8.9 All charities are acutely aware of the risk the above factors pose and most have in place good systems designed to minimise any such risks. However, complete assurance is not possible. Auditors in New Zealand are aware of the systems but commonly qualify the audit report in respect of being unable to verify that all the donations have been recorded. It is impossible to verify donations that are not there.

8.10 Another potential area where an audit report may be qualified relates to building valuations. Particularly for Churches their buildings are used for the purposes of the charity and not in a revenue generating manner. There is often no realistic alternative use nor, often, does the Parish have the option of disposing of the building. There is no demand from members to spend money having the church periodically revalued. The auditor may feel compelled to qualify the accounts because such accounts may not show market valuation.

9. Question 9

Q9 Do you consider that there should be a mechanism for the government to increase the dollar amounts from time-to-time to counter the effects of inflation?

9.1 Yes.

10. Question 10

Q10 Do you have any views on the Ministry's estimates of costs and benefits?

10.1 The Churches consider the costs estimates are too low for the reasons set out in paras 8.5 to 8.7

10.2 The Churches struggle to see the commensurate benefits at the very low levels proposed, especially for audits.

11. Question 11

Q11 Do you consider that introducing a review requirement into law could encourage some charities that are currently having an audit carried out to switch to a review?

11.1 Perhaps.

12. Question 12

Q12 Do you have any other comments?

12.1 The requirement for an audit or review should not be imposed earlier than 2016 to allow time to adjust. Prior period figures will need to be audited so this effectively means 2015 figures being audited.

DATED at Wellington 20 July 2012

G. B. H. Robertson

Gillian Robertson (Mrs)
Chair
Inter Church Working Party

Appendix - List of Churches

Member Churches

Inter Church Working Party

The following Churches and Christian organisations comprise the Inter-church Working Party:

Acts Churches New Zealand (formerly The Apostolic Church Movement of New Zealand)

The Anglican Church in Aotearoa, New Zealand and Polynesia
Te Hāhi Mihinare ki Aotearoa, ki Nui Tirenui, ki ngā Moutere o Te Moana Nui a Kiwa

Assemblies of God in New Zealand

Baptist Union of New Zealand

Catholic Churches of New Zealand

Christian Churches New Zealand

Congregational Union of New Zealand

Elim Church of New Zealand

Lutheran Church of New Zealand

The Methodist Church of New Zealand
Te Hāhi Weteriana o Aotearoa

Missions Interlink NZ

New Life Churches of New Zealand

New Zealand Christian Network

New Zealand Council of Christian Social Services

Open Brethren Assemblies

The Presbyterian Church of Aotearoa, New Zealand

The Religious Society of Friends (Quakers), Aotearoa New Zealand
Te Haahi Tuuhauwiri

Scripture Union in New Zealand

The Salvation Army
Te Ope Whakaora

The Seventh-day Adventist Church in New Zealand

Uniting Congregations of Aotearoa New Zealand