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Competition, Trade and Investment Branch
Ministry of Economic Development
PO Box 1473
WELLINGTON

Dear Sir/Madam

This letter is in response to the call by the Ministry of Economic Development to comment on the Discussion Paper on the Auditing and Assurance for Larger Registered Charities, issued in April 2012.

I provide this response on my and the Manawatu Technical and Legislation Special Interest Members Group of the New Zealand Institute of Chartered Accountants behalf. This special interest group consists of a number of Manawatu based small and medium size practitioners who currently provide assurance to a variety of entities, including charities of varying size.

In principle we agree that the quality of financial reporting in charities sector is varied and should improve. We also agree that requiring assurance, at least for some entities in the charities sector, might lead to improved quality of financial reporting and improved comparability of financial statements for that sector.

However, we have some reservations regarding a number of details in the proposals outlined in the Discussion Paper. To that effect, please find in the attached document our detailed responses to the questions from the Discussion Paper.

We hope that you will find this feedback useful. I am willing to provide further information on the matters raised in this letter should you wish to contact me.

Yours sincerely

Dr Nives Botica Redmayne
On behalf of the Manawatu Technical and Legislation
Special Interest Members' Group
of the New Zealand Institute of Chartered Accountants

Responses to the questions in the Ministry of Economic Development Discussion Paper – Auditing and Assurance for Larger Registered Charities

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

The problem, as it is described in the Discussion Paper, Section 2, is in our opinion not well defined. The description provided in the Paper, in that section, outlines issues with financial reporting of charities. We agree that quality of reporting and consistency of financial information provided by charities in New Zealand needs improvement. However, Section 2 of the Paper does not explain how assurance is to improve that situation. The appropriate and mandatory financial reporting framework for charities is, in our opinion, a first step in insuring improvements in quality of reporting and consistency of financial information/reports for charities. As a matter of fact such a framework is essential for assurance to be adequately performed and to add any value to financial reporting. An appropriate and regulated financial reporting framework is a pre-requisite of an assurance process as it represents a criteria against which a subject matter, such as financial reports, are evaluated in order to provide an assurance. Further in the Discussion paper (paragraphs 20, 31 b and 33) the Paper suggests that legislating assurance of large charities is to be in the interest of "...increasing quality and reliability of financial statements...", "...promoting higher quality GAAP- compliant reporting..." and "Ministry considers that it is in the best interest of charities of \$500,000-plus charities to choose to have an assurance engagement completed for governance and financial management reasons". We deduct from all of that that the main reason for the proposed regulation is to improve financial reporting of charities and to enable consistency of financial reporting for charities.

We would also like to offer a further insight into other characteristics of assurance as a service. This insight might be useful in the description of the problem definition and the description of the objective for the proposed regulation. Assurance, especially where regulated, does provide regulatory compliance, but more importantly from the assured entities' point of view it provides a control function. The control function, in terms of control over probity might be more important from public and potential funders/donors point of view (as suggested in paragraph 17 in the Discussion Paper) than the actual production of appropriately formatted financial information. Therefore, in our opinion, there should be given some consideration to the role of assurance in probity in charities sector.

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

We consider that the overall objective of proposed regulation needs to be clarified. That is, is the objective of the regulation to improve financial reporting of certain size entities by expecting assurance providers to contribute to those charities' compliance with appropriate financial reporting frameworks? Are there any other objectives that regulation of assurance over charities' financial statements is expected to achieve in terms of benefits to public, potential funders and donors, such as probity? Is regulating the assurance of financial statements expected to add to governance and financial management of charities of certain size (as suggested in paragraph 31 b in the discussion paper)? If so, is there a problem at the moment with the governance and financial management of certain size charities? Please see also our comments regarding problem definition in our response to question 1.

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

We find the description of options useful although possibly the description of differences between an audit and a review engagement could be more informative from the users, funders and donors point of view. As our respondents are currently assurance providers they all understand reasonably well the difference between an audit and a review. We consider that the option of Independent Examination might be easily confused with a review engagement and therefore even more confusing for the users of charities' assurance reports. Therefore we are pleased to see further in the Discussion Paper (paragraph 37) that Independent Examination system is not carried forward as an assurance option in New Zealand.

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

In principle we do agree that large charities should be required by legislation to have an assurance engagement completed. That is because we consider that the quality and consistency of financial reporting in charities sector in New Zealand needs improving and we do think that regulating assurance will add to that process of improvement. However, we consider that there is a larger problem on issue in the charities sector (as per paragraph 33 in the Discussion Paper). That is, that some large charities, in spite of being required by their constitution to have assured financial reports, continue to not have assurance. That, in our opinion, is a matter of compliance with founding documents of individual charities. It is also a responsibility of the governing body of a charity and requires establishing some monitoring mechanism, via Charities Commission or some other agency, to ensure the compliance. **Assurance providers cannot assure on the compliance with a constitution if they are not approached to be engaged in the assurance engagement.** Therefore, regulating assurance of certain size charities is likely to resolve the problem of those but not all charities not complying with assurance requirements in their founding documents. Some further thought should be given by the Ministry on how compliance is to be monitored for all charities.

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?

We find this question confusing. This is because of the lack of precise definition of what terms 'large', 'larger', 'less large' and 'more large' really mean. These terms are used throughout the Discussion Paper but so are size measures in terms of dollars of expenditure of \$40,000-100,000, \$100,000-250,000, \$250,000-\$500,000 and > \$500,000 (paragraph 30), \$300,000 and \$200,000 (paragraph 62). The Ministry should also consider how the proposals in the Discussion Paper correspond with current financial reporting framework for PBEs, particularly Tier 3, not-for-profit sector and the cut-off points for reporting standards in that tier. Introducing more and different cut-off points for assurance requirements in that tier might potentially cause confusion amongst charities, assurance providers, funders and donors regarding who is to report how and who is to have assurance of what type. Should the Ministry maintain that assurance regulation cut-off points are to be different from the reporting cut-off points, our suggestion is to use one definition of large and non-large charity with a possible use of tier cut-off points such as <\$100,000, \$100,000-\$500,000 and >\$500,000 of charity's expenditure. We then suggest that charities over \$100,000 in expenditure are deemed to be large and below that limit

non-large. We suggest that entities below \$100,000 have optional assurance (based on the requirements of their constitution or funders requirements), charities in the \$100,000-\$500,000 band have requirement for a review and the over \$500,000 charities have a requirement for an audit.

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?

We consider that, given the nature of most charities' operations, operating expenditure is the most appropriate measure for determining whether assurance of certain size charities is to be required. Our assurance practitioners also consider that total assets can be used as a complimentary measure to operating expenditure measure. This is because some charities might be "rich in assets" but somewhat non active in certain reporting periods and therefore not incur significant expenditure. In addition, some charities may provide significant grants to the community which might be accounted for as distributions from equity rather than expenditure. That is why a combination of measures might be a better choice when determining the assurance regulation cut-off points. We also would like the Ministry to give some consideration to the transitional, and the 'opt-in/opt-out' arrangements when a charity in one period crosses over into a band requiring assurance but falls out of that requirement in a following period.

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

In answering this question we assume that "qualified accountants" referred to in Option B are defined as auditors with qualifications as described in the New Zealand Companies Act 1993 (and as stated in Table 7 and paragraph 57 in the Discussion Paper). Providing that the overall objective of the large charities' assurance regulation is to improve financial reporting quality and consistency of reporting by large charities (which is what the title of the Discussion Paper suggests), Option B is our preferred option. This is because, in our opinion, only qualified accountants are likely to understand the reporting requirements of such large charities and be able to have appropriate assurance standards knowledge so to assure on them.

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?

We consider the suggested bands too narrow. Please also see our comments and suggestions to question five (5).

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

Yes, we suggest a regular review of dollar amounts, say, at least every 5 years.

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

We consider the estimates, particularly the assessments of the cost of assurance, too simplistic. There is a large body of research on assurance fees, audit fees in particular. This research suggests that assurance fees are a function of assured entity's size but only in a combination with assured entity's complexity and risks associated with the assured entity. Other characteristics of an assured entity might contribute to the cost of an assurance but the combination of measures of assured entity's size, complexity and risk usually explains 70-80% of an assurance (audit) fee and has been proven to have high explanatory power over time and in different settings. The relationship between the assurance fees and assured entity's size is also non-linear due to some economies of scale when conducting a lot of assurance engagements in the same industry or sector (i.e. assurance provider's investment and return on specialisation). The complexity as a function of assurance fees is often measured by a number of branches or subsidiaries that make an entity or a number of reports that assurance provider needs to assure on. The risk associated with financial information assurance generally stems from financial performance and the financial viability of the assured entity. However a contributing risk factor in the assessment of risk is also quality of internal controls that assured entity uses to conduct its operations and to produce the assured financial information. We suggest that Ministry consider re-assessing and increasing the estimates of the potential assurance costs.

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?

The suggested switch to a review is a distinct possibility, especially if cost of assurance is a consideration from the assured entity's point of view and there is a difference in assurance providers' costing of provided audits vs. reviews. However, there seems to currently be a wide-spread lack of understanding of differences between an audit and a review engagement. This is the case not only on the part of the assured entity, funders and donors but also on part of some assurance providers (please see the article: Botica Redmayne, N., Malthus, S. (2011). Limited assurance standards: does one size fit all? *Chartered Accountants Journal*, 90 (8), pp. 26-28.; full paper can be provided on request). Our practitioners suggest that in practice the effort to complete a review engagement is not that dissimilar to the effort to complete an audit engagement so the costs of those two types of assurance engagements are similar. There seems to be, at least at this stage, a distinct preference by assurance providers to offer an audit as an assurance engagement rather than a review, due to a perceived lack of demand for review engagements. So, there is a need to educate governing bodies of assured charities, founders and donors on what the differences are between an audit and a review engagement and the suitability of those two types of assurance engagements to particular entities and particular situations.

Q.12 Do you have any other comments?

We would like to encourage the Ministry to think about the possible mechanisms for monitoring certain size charities' compliance with proposed regulation as well as compliance with provisions for assurance in all charities' constitutions.