

SUBMISSION

NEW ZEALAND
INSTITUTE OF
CHARTERED
ACCOUNTANTS

DISCUSSION PAPER
Auditing and Assurance for
Larger Registered Charities

20 July 2012

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Assurance for Larger Registered Charities
Competition, Trade and Investment Branch
Ministry of Economic Development
PO Box 1473
WELLINGTON 6140

Dear Sirs

Submission on Discussion Paper: Auditing and Assurance for Larger Registered Charities

The New Zealand Institute of Chartered Accountants (NZICA) welcomes the opportunity to comment on this Discussion Paper.

NZICA has over 33,000 members who work across New Zealand and the world. Our members operate throughout the economy, participating in and advising all types of businesses, entities and individuals.

We have outlined below the main areas that we believe you should further consider as you proceed to establish requirements for auditing and assurance for larger registered charities. In Appendix A we have provided our responses to your specific questions raised in the Discussion Paper (DP), many of these responses reflect the areas highlighted below.

We fully support the Ministry of Economic Development's (MED's) efforts to improve the quality of financial reporting in the NFP sector and in particular for registered charities. Significant amounts of money flow through registered charities and in this light we strongly support measures to improve their financial management, accountability and transparency. We also fully support a continued but more structured participation by our Chartered Accountants as assurance providers and we believe this will go some way to improving the quality of financial reporting by registered charities, although we do think that there are a number of other important factors that contribute to the same objective that should not be ignored (and are discussed further below).

Although supportive of the overall aim of improving the quality of financial reports prepared by larger registered charities, we do believe there are some areas that require further consideration. These areas are expressed below:

1. MED has expressed in the DP that assurance is required to achieve a higher level of confidence in the financial reporting of registered charities given that some accountants are currently not preparing their financial statements adequately. Whilst we support initiatives to improve the financial reporting quality of registered charities, we believe that MED should take a wider perspective on how this may be accomplished. A key issue in the debate on the quality of financial reports of registered charities is that current GAAP was not designed for the NFP sector which we view as also causing a lack of consistency in financial reports. We believe the announced changes to the financial reporting framework that clarify the reporting

requirements for registered charities and the External Reporting Board's on-going work to develop financial reporting standards specifically for NFP's will be significant in improving the consistency and overall quality of financial reports prepared by registered charities. The discussion, therefore, may benefit from a broader consideration of whether other options may exist to address MED's concerns.

2. One possible alternative or supplement to a statutory based assurance regime, we suggest for discussion, may be the reinforcement of an in-house (i.e. Department of Internal Affairs) related compliance capability. Such additional resource may comprise Chartered Accountants performing periodic procedures of registered charities' financial statements targeting the already identified areas that MED is concerned with. The benefit of such an approach may include; potentially lower overall costs to the sector, a more concentrated risk-based approach and greater penetration (i.e. a rotational program covering more registered charities).
3. The discussion regarding compilation engagements as a measure to address the stated problem could be expanded. Although not an assurance product, members that compile financial statements apply compilation procedures involving the use of accounting expertise. Users derive benefit because our members are required to carry out work with professional competence and due care, and are subject to the ethical and other professional standards issued by the Institute. Members are required to disclose known departures from GAAP in their reports. Whilst we acknowledge that MED may not wish to impose on registered charities who may prepare their financial statements, such a requirement could be optional and if registered charities elect to file their financial statements with a compilation report attached perhaps they may be permitted to not have an assurance engagement (eg. from \$200,000 up to a set amount-"the lower end of the spectrum"). This may be a useful option when considering likely increased concentration of the audit market and potential related supply issues (i.e. in respect to the tentative proposals).
4. We believe that the discussion could also be extended to consider who the users (or non-users) of the financial statements of registered charities are, and what their assurance needs may be. Anecdotal evidence would suggest that those that are users (i.e. funders) of registered charities' financial statements are also likely to be in a position to demand assurance on the financial statements, whereas small-scale public donors are not in a position to demand any form of assurance but would also not likely use audited financial statements as part of their decision to donate. Both funders and public donors may find use (albeit indirect) in assurance work on whether the monies given have been put to stated or contracted use. Therefore, we believe further discussion around assurance alternatives that benefit the users (and non-users) of registered charities' financial statements should be undertaken.
5. In respect to who can perform the proposed assurance work, we are supportive of MED's proposal to restrict this to licensed auditors, registered firms, chartered accountants or overseas qualified accountant recognised by the Registrar of Companies. This is consistent with the requirements for other statutorily imposed non-issuer audits or reviews and should result in an overall higher quality of assurance when considering MED's other options. Under NZICA's Rules, our Chartered Accountant's would only be able to provide such assurance services if they are holders of a Certificate of Public Practice. In our view, and as reflected in the auditing and review standards, it is important that the work should be carried out by individuals sufficiently competent to perform assurance engagements and we are considering further initiatives to establish additional requirements where our Chartered Accountants are performing assurance work directly required by statute. The impact of these changes is further concentration of who can perform audit work, which may impact the supply of chartered accountants able to carry out the work outlined in MED's tentative proposals.

6. The interplay between paragraphs 49 and 54 of the DP implies that performing a review is easier than performing an audit. Anecdotal evidence suggests that this is not necessarily the case. In our view, the performance of an effective and efficient review engagement requires a fairly high degree of competence and experience in order to avoid doing too much work or doing too little work. Typically review engagements are performed by Chartered Accountants in addition to performing an audit engagement for the same client (i.e. an interim review); the existence of the audit engagement significantly helps with the efficient performance of the review engagement. Furthermore we note that the international standard that outlines requirements for conducting review engagements has recently changed and that these changes are likely to be applied in New Zealand in the future. We understand that the new requirements will increase the quality of the review engagement (i.e. an implicit increase in effort). In view of these comments, we think further discussion is required to understand whether the cost/benefit scenario that MED envisages with a review engagement option will actually crystallise, especially for registered charities at the level of \$200,000 - \$300,000 in operating expenditure.
7. We think the information provided about the cost of assurance in the DP could have been more reliable and relevant. Whilst being fully supportive of MED's need to consider the cost of the proposals it makes, such analysis needs to be undertaken with more appropriate information. Based on our discussions with members, it seems that the cost information presented is not likely representative of the current market and will certainly not be representative if MED's proposals are finalised in their current form because the amounts are too low. Furthermore, there are a number of other factors that should be considered in analysing the cost of the tentative proposals, including;
 - a. An increasing level of auditor concentration
 - b. Increased standardisation of the underlying work
 - c. Changes to standards on audits and reviews
 - d. Changes to the accounting framework.

This apparent underestimation of the cost of assurance leads us to believe that the thresholds proposed are too low. We suggest that MED conduct further work in this area in order to improve its analysis of the cost/benefit equation.

8. The use of the terms "larger" and "large" needs to be clarified. Our understanding is that the Cabinet papers regarding the proposed changes to New Zealand's financial reporting framework established that a large registered charity was that with \$2m or more in annual operating expenses. Paragraph 57 of the DP emphasises the importance of taking a consistent approach from Act to Act and we assume that if a consistent approach was taken an assurance requirement would only be required for registered charities with annual operating expenses of \$2m or more. We believe further discussion around how the accounting framework thresholds should align with the requirement for assurance would be well received.

If you have any questions regarding this submission, please contact John Hodge (Director-Technical Services) on 04 460 4600 or john.hodge@nzica.com.

Yours faithfully



Terry McLaughlin FCA
Chief Executive

APPENDIX A

Responses to Specific Questions

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

We agree that there is a wide range of quality in the financial statements of registered charities that get filed with the Charities Commission and that this needs to be addressed. We think the reason for this is largely that there are currently no specific financial reporting standards for registered charities.

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

We agree with MED's discussion on the objectives of charity regulation and GAAP reporting. However, we view that MED has oversimplified the issue when it states "absent assurance, users of financial statements are fully reliant on the reporting entity to prepare the financial statements in accordance with GAAP" without identifying and discussing who the users are and what their needs and powers to request assurance are in addition to other means to increase compliance with GAAP.

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

In respect to the stated assurance options; we agree that an audit and a review are two of a number of potential assurance and non-assurance options available. We agree that it is not well understood that a review is available as an alternative form of assurance, and we agree that there are varying degrees of quality in the reviews carried out. We note that the Statement of Review Engagement Standards is very dated and the international standard is in the process of being updated.

Our understanding is that funders/donors really want to know:

- (a) the entity actually exists;
- (b) the entity is financially viable; and
- (c) the funds have been expensed for the purpose they were granted.

Although, to a certain extent, an audit and a review address both (a) and (b), neither really addresses (c), therefore a compliance engagement conducted under SAE 3100 and ISAE (NZ) 3000 might be a more appropriate option to address all of the above assurance needs of the users (or non-users) of the financial statements.

However if the main objective is to ensure that all registered charity financial statements are in compliance with GAAP, then perhaps a compilation engagement performed by a Chartered Accountant (i.e. with compilation report) may also be useful. Although this is a non-assurance engagement, the users can still derive comfort from the fact that a Chartered Accountant has compiled the financial statements following robust professional standards.

Another option may be an agreed-upon procedures report. With this form of report the Chartered Accountant is not providing assurance but is reporting factual findings in response to set procedures. One advantage of this kind of engagement is that the Chartered Accountant can target specific areas in an efficient and effective manner. The main disadvantage surrounds the 'audit expectation gap', that is a perceived level of assurance over the financial statements compared to actual (i.e. no assurance).

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

Yes. However, we would encourage further discussion on the needs of users, particularly those that are not in a position to demand assurance, and what type of engagement is appropriate.

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?

Our view is that further discussion needs to be had around the assumptions that for a registered charity with operating expenditure of between \$200,000 and \$300,000 a Chartered Accountant would be able to crystallize the cost savings to the extent envisaged by MED for a review engagement. In the absence of further discussion our view would be to have an audit requirement only for assurance and other options should be considered for 'less larger' registered charities such as the option of a compilation engagement or an agreed upon procedures engagement.

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?

The logic of using annual operating expenditure is generally well accepted in the sector. It is consistent with the measure used for the financial reporting framework tiers, so would minimise confusion. However it may be open to manipulation with the netting down of expenditure with income, particularly with the treatment of volunteering. Some members also voiced concern about not using a revenue or asset based test. We think there is merit in having these measures considered in the threshold as well as operating expenditure; some registered charities have significant amounts of assets but relatively low amounts of revenues and expenses.

Q7. Do you prefer Option A, Option B or another option in relation to assurers' qualifications?

Option B is preferred here. We do not believe MED should require assurance and then not have appropriate measures to satisfy itself that such work is being undertaken by competent qualified individuals.

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?

Any threshold is going to be arbitrary. The thresholds do appear to be too low to us, and we would encourage further discussion around non-assurance engagement options should the amounts be retained at this level. For example, one suggestion may be \$200,000-\$1,000,000 in operating expenses requires either a compilation engagement or an audit engagement and \$1,000,000 in operating expenditure and above requires an audit engagement.

Some members have suggested the use of qualitative measures, for example whether registered charities seek funding from the general public or not.

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?

We agree that the thresholds will need to be periodically reviewed and revised if necessary to ensure they remain appropriate.

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

Quantifying the cost of assurance may have the unfortunate consequence of creating unrealistic expectations which may impact the quality of the assurance provided. The cost of assurance will vary from entity to entity and is based on the risk profile and the complexity of the assurance engagement. The feedback we have received from members suggests that the data provided by MED on the costs is not representative of the market (i.e. current and assuming proposals are finalized). In considering the current environment in which assurance is being provided to registered charities, the following points need to be considered:

- i) Section 15 of the NZICA Act 1996 states there is nothing which prevents any person from acting as auditor of a club, institution or association which is not carried on with a view to profit. Any person who is not a Chartered Accountant is not obliged to follow the ethical and professional standards and the assurance standards for these engagements. This means that there may be a wide range of quality of assurance work currently carried out with significantly different cost structures in place.
- ii) Currently there are no financial reporting requirements for registered charities, which means there is often inconsistent accounting in financial reports filed with the Charities Commission. An audit of a set of financial statements prepared in accordance with GAAP, as per the proposals, would be far more involved. Therefore we consider the costs are expressed on an inconsistent basis to the proposals in this regard.
- iii) Some audit firms currently provide audit services to registered charities on a pro-bono basis (including reduced fees). Firms may be more inclined to perform pro bono work for registered charities only in cases where no statutory audit requirement exists.
- iv) The Charities Commission "Officer Kit" refers to the "Community Resource Kit" published by the Department of Internal Affairs (DIA). Section 7: Financial Management (updated April 2011) refers to there being "four different levels of audit". This in itself is misleading; a registered charity may have had a "level 4 audit" comprising an independent verification, but have called it an audit.

Therefore, our view is that the data provided in the DP on costs is not particularly helpful to the discussion in its current form.

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?

We have no particular view on this.

It is common for registered charities documents (rules, constitution, trust deed etc) to require the annual financial statements of the entity to be audited. In many cases these documents were set up from a standard legal template, prior to the existence of the codified auditing standards, and have not been updated since. Therefore such change would necessitate changes to these documents which may act to inhibit the extent of such a change.

Q12. Do you have any other comments?

No.