

## Comments on Proposed Changes to Audit for Registered Charities

Initial comment:

The Discussion Paper (DP) from the Ministry of Economic Development (MED) in April 2012 invited submissions on 12 questions listed in the DP and summarised at the end. This submission will address those questions, but this initial comment refers to the inter-relationship of the subjects in those questions. The DP defined the problem, the objective, reviewed various options to overcome the problem, and then tentatively proposed the best option as the solution to the problem. However, the comments below note that the definition of the problem is incomplete or inaccurate, which impacts on the various options that are available and the best solution to the perceived problem. In order to meet the quite strict guidelines in the DP for making submissions, the comments below do not pursue the ramifications of these inter-relationships, except for a brief note in reply to the last question that invites other comments.

### Question 1: comments on the description of the problem definition.

Charities file financial statements with the Charities Commission (CC). Those statements do not need to be audited, and there are no accounting standards governing their preparation. The DP states that consequently the statements use

“diverse recognition and measurement approaches, including some that are inconsistent with generally accepted accounting practice (GAAP)”.

It is more accurate to state that the accounting standards that conform to GAAP are silent with regard to some activities and transactions that are often undertaken by charities. For example: charities employ volunteers and receive donated goods (both capital assets and revenue items) and services. The accounting standards that comply with GAAP have been developed to apply to businesses where those types of transactions are very rare. This point is relevant in relation to the problem noted in paragraph 13 of the DP that

“some accountants employed by charities have not kept up with GAAP or hold the view that GAAP does not apply in the not-for-profit sector.”

Most of the accounting principles, standards, and practices, within GAAP **do** apply to charities, and are applied by charities in their financial statements; but some common activities of charities are beyond those governed by GAAP.

The DP describes the accounting standard for not for profit (NFP) entities that is currently being developed by the External Reporting Board (XRB), including the simple format reporting (SFR) for NFP entities where annual expenses are less than \$2 million. When the new XRB standard is implemented the DP expects an improvement in the quality of the financial statements in contrast with what it describes as:

“widespread non-compliance with GAAP by registered charities at present”.

That assessment of the present situation seems unduly harsh, unfair, and inconsistent with the financial statements of charities that we have seen. Reasons to disagree with the assessment of “widespread non-compliance” are:

- Most charities (three-quarters of those required by their Constitution) file audited accounts and usually the audit report states whether the accounts comply with GAAP. Usually the audit report gives an unqualified opinion.
- If there were widespread non-compliance then there would be comments about that situation in the media, from community leaders, politicians, donors, and even by the judiciary in trials involving dishonesty.
- There is very little specific or direct evidence in the DP to confirm this assertion. The DP refers to a thesis by Dr Sinclair that has generalised notes of some accounting practices that do not comply with GAAP.

Whilst there is always room for improvement, and the standards being developed by XRB should result in better quality financial statements, it is not fair to describe the problem as “widespread non-compliance with GAAP”

Paragraph 13 of the DP cited observations by Dr Sinclair of

“many instances of poor quality financial statements prepared by accountants, which resulted in meaningless financial statements that did not tell the story of the charity”.

As this assessment is generalised it is difficult to evaluate its credibility or give it much weight in defining the problem. However, those observations imply that accountants prepare some meaningless financial statements that are accepted by the managers and members of the charity. If it were assumed that accountants prepare meaningless financial statements then it is incredible that the charity’s managers and members accept those statements. The members and managers of most charities are passionate about the charity and vocal in telling their story. They will not approve meaningless statements, but use the annual report to broadcast their story to the community and to current and potential funders.

Paragraph 14 of the DP refers to Dr Sinclair citing:

“several examples of practices that are fundamentally inconsistent with GAAP, such as not including donated assets (because there was no cash transaction)”.

The accounting treatment of donated assets is a difficult issue because: under the matching principle the benefit of owning an asset should be spread over its useful life, but under the historical cost principle the asset cost nothing so there is no cost to spread. As regards GAAP: the majority of charities will in future be covered by SFR, and a reasonable indicator of the standard that will be published is the report by the working group of the XRB that stated at paragraph 44:

“The Working Group considered the arguments for and against including goods in kind received as revenue. Its view is that the costs of reporting such items as income are likely to outweigh the benefits...”

And at paragraph 48:

“Consistent with the decisions above, goods in kind received should not be required to be included as an asset as the costs of doing so are likely to outweigh the benefits for Tier 3 entities.”

Therefore, the treatment of not including donated assets in the balance sheet is not fundamentally inconsistent with GAAP but is in accord with the best estimate of the relevant part of the SFR standard that XRB will publish.

Paragraph 15 of the DP refers to Dr Sinclair’s descriptions of several ways that accountants use to manipulate financial statements to make charities appear to be poorer than they actually are. The paragraph states that:

“such practices might be at risk under section 260 of the Crimes Act 1961, which relates to false accounting”.

But the DP does not state whether the Police have been invited to investigate instances of such practices or whether the CC or the MED review the financial statements from charities for indications of the accounting practices described by Dr Sinclair. The DP tarnished the reputations of all charities but only a few charities manipulate their accounts. If charities are involved in criminally false accounting then the Police or Serious Fraud Office should investigate them and take whatever prosecution is appropriate. The right response to such problems is to review the financial statements filed and prosecute or penalise offenders. It is an inappropriate response to this problem to impose increased audit or review on all larger charities because a small proportion of charities manipulate their financial statements or carry out criminally false accounting.

According to Table 4 in the DP approximately 75% of charities, where their Constitution requires them to obtain assurance on their financial statements, file financial statements with such assurance. The proportion is similar regardless of the size of the charity. The problem is that about 25% of charities may not be complying with their Constitution regarding assuring their financial statements. Such behaviour of charities is not policed and there is no penalty for a charity that does not comply with its Constitution. The DP proposed that about 1500 charities obtain assurance in future who do not do so at present, but about one third of that 1500 are required by their Constitution to obtain assurance and do not file such assured financial statements. This is a very serious problem that is not included in the definition of the problem in the first part of the DP. The CC or MED should police cases where charities file financial statements that are not assured but their own Constitution requires such assurance. If a charity fails to comply with its Constitution in this regard then there should be some sanction such as withdrawal of registration of the charity.

Paragraph 16 of the DP notes that the XRB is developing standards for charities to prepare integrated reports that include both non-financial and financial information. But that paragraph states that the new standard alone is not sufficient and that:

“assurance is needed to provide confidence that charities are presenting an accurate picture, promoting public trust in charity and providing the information that the individuals involved in the charity’s governance need to manage the charity’s resources efficiently and effectively.”

This looks like defining the problem towards a pre-determined solution. The DP does not say why the new standard that the XRB will publish is insufficient, or how the expected new standard and this assurance requirement will combine to solve the problem. If assurance is required after the new XRB standard is issued, then it seems that assurance was required in the past and present environment. Therefore, why is this assurance requirement being proposed now?

The last phrase cited above states that assurance is required to provide the information that the managers of the charity need to manage its resources. This is false because the assurance refers to the annual published financial statements (and in future the integrated report), but, to govern a charity, the managers usually use financial records that are not subject to audit or assurance, such as the budget and monthly financial reports.

Paragraph 46 of the XRB working group report in November 2011 stated:

“The Working Group considers that given the strong public interest in fundraising, that entities that undertake public fundraising (i.e. solicit donations from the public with little or no direct exchange in return), should be required to have a note to the financial statements that identifies net fundraising proceeds. This should be a compulsory requirement for all entities that undertake public fundraising.”

It is odd that the DP does not mention this proposed compulsory requirement for NFP charities that undertake public fundraising. The omission may imply that this issue is not a problem. It definitely is a problem as there is significant public interest in those net fundraising proceeds, and the related problem is whether such disclosure needs to be covered by audit or assurance.

This issue illustrates a shortcoming in the DP: it regards the problem as being that the financial statements of charities are not complying with GAAP, and proposes to solve that problem by forcing charities to obtain assurance and thus increase compliance with GAAP. The problem is that charities do not disclose in their financial statements the information that the public need to know, such as the net fundraising proceeds of charities that solicit donations from the public.

This issue illustrates the fallacy of concentrating on GAAP instead of responding to the strong public interest in charities providing certain specific information (including non-financial information such as the number of volunteers and hours they work). As noted above, GAAP is a body of accounting practices developed for businesses such as the recognition and measurement of income from sales of goods and services; but they do not cover the accounting practices where a charity solicits or receives donations of money or goods, because businesses generally do not undertake such activities - they make sales.

Therefore, in summary, this submission comments as follows on the definition of the problem in the DP:

- The DP states that charities use diverse accounting approaches, including some that are inconsistent with GAAP, but really the problem is that GAAP does not cover some activities frequently undertaken by charities such as employing volunteers and receiving donated goods or services.
- The DP unfairly describes the problem as widespread non-compliance with GAAP by charities which seems very harsh in view of: most charities file audited accounts that either comply with GAAP or have a qualified audit report, lack of media reporting of non-compliance, and the absence of clear evidence in the DP to confirm such widespread non-compliance.
- The DP cited research that some accountants prepare meaningless financial statements for charities. This generalised assessment is not credible as most people involved in charity work are passionate about broadcasting what they do, including using financial statements to tell that story. Those people would not accept such meaningless statements.
- The DP stated that not including donated assets in the balance sheet is fundamentally inconsistent with GAAP, but such treatment is actually in accord with the likely relevant part of the SFR standard that XRB is expected to publish (and SFR will cover 96% of charities).
- The DP cites an observation that some charities use criminally false accounting to make their financial statements show that they are poorer than they actually are; but the problem is that such behaviour is not reported to the Police or SFO and the perpetrators are not prosecuted.
- According to the DP about one quarter of all charities who are required by their own Constitution to have their financial statements assured or audited do not file such assured financial statements with the CC. The DP does not include this as a problem. This non-compliance by about a quarter of charities with their own Constitution is a serious problem that affects the credibility of charities generally.
- The DP stated that the new standard for SFR being developed by XRB is not enough to provide confidence that financial statements present an accurate picture and promote public trust in charities; but the DP does not state why it is insufficient. It does not say how these accounting and audit changes will work together, or why this proposal to require some charities to have their financial statements audited is proposed now.
- The DP stated that one reason to require assurance is to provide the information that the individuals involved in the charity's governance need to manage the charity's resources efficiently and effectively. Management reports (such as monthly financial statements and budgets) are not usually subject to assurance. Usually assurance covers the annual financial statements that contain general-purpose, public, information.

- A problem is that some charities are not providing in their publicly available financial statements the information that the public are interested in knowing, such as the net fundraising proceeds of charities that solicit donations from the public with little or no direct exchange in return. That information is likely to be required to be disclosed under the new standard SFR being developed by the XRB; but the DP does not mention this problem or whether such disclosure should be audited.

### Question 2: comments on the description of the objective

The DP states that the objects of regulation of charities are to protect society from misrepresentation and to require disclosure of financial information. It states that the object of GAAP reporting is to standardise the treatment of transactions, disclosure, and format, in financial statements. According to the DP its objective is to balance the benefit of assurance of greater compliance with GAAP against the additional cost of obtaining such assurance. This is quite true, but it is incomplete and also seems to be a low level objective.

It seems that the regulations should also have the objective of protecting society from charities that do not comply with their own Constitutions. For instance under the regulations the government should review and investigate where a charity is not following its Constitution, and regulate the consequences in such cases. Government sets the environment within which charities operate and therefore the government should police such non-compliance by a charity. In this context: the DP states that where a charity's Constitution requires assurance of the financial statements, only three quarters of charities file such assured financial statements – and the objective of the regulations should be to raise that proportion to 100% compliance.

The DP states that its objective is to balance benefit of assurance against the cost of such assurance. This submission is that the DP should aspire toward higher objectives, like improving the standards and disclosure in financial statements, or improving the governance and accountability of charities. When the XRB issues the new standard for SFR it is very likely to assist charities to achieve the former objective. However, the DP focus is on cost benefit analysis, instead of on the place of charities in society and how to assist them to fulfil that role.

### Question 3: comments on the description of the options

The DP stated that the main options are to require by legislation that large charities have their financial statements assured, and in that case whether: the assurance should be by audit or by review, the measures and thresholds where such assurance is required, and the qualifications of the auditor or reviewer. It described and compared the audit and review process and also summarised the “independent examiner” approach to assurance used in England and Wales.

The DP did not consider any alternative to requiring assurance by legislation. It seems heavy-handed to move from the present situation where there is no requirement for charities to have their financial statements audited or reviewed, to require such assurance by law. There is no mention in the DP of penalties for non-compliance with such legal requirement, or whether that legal requirement will be policed. For instance: a non-compliant charity may be removed from the register, its officers may be fined or imprisoned, or the new law may be a legal requirement that is not policed and where non-compliance does not have any adverse consequences for the charity or its officers. Where a law is not enforced (not policed and without penalties for non compliance) it is generally bad law.

There are alternative options to requiring assurance by legislation that may also improve the quality of the financial statements of charities. For example the **new standards** for NFP entities that the XRB is expected to publish will undoubtedly bring such improvement. The **education** within the NFP sector when the new **SFR templates** are introduced is likely to raise awareness of the need for high quality, reliable, financial statements. Another option is that the **CC or MED reviews** the financial statements when the charity files them, and is **empowered and authorised to investigate** queries that it notes from such review.

The DP adopts a blanket approach to all charities above a certain size that it describes as large. As noted above “there is significant public interest in the net fundraising proceeds of NFP charities that solicit donations from the public” whereas by contrast there is probably very little public interest in charities that receive funds from a non-public source and distribute those funds to other charities. This submission is that the new assurance regime should be **targeted to meet the public needs** regarding the financial statements of charities.

The DP seems to aim for a culture change within charities so that they will file financial statements of high quality, GAAP compliant, and reliable. It seems that such a culture change is more likely if the rules are partly voluntary and involve gently increasing pressure to comply, than if there is a sudden blanket legislative compulsion. The first change may be to: require audit for Tiers 1 and 2 charities (where annual operating expenses exceed \$2 million), the SFR standard applies to the remaining charities, the XRB would educate charities about how to use the SFR templates, and the CC would actively police cases where charities filed financial statements that were not audited or reviewed but the Constitution of the charity required that they should be audited or reviewed. After a reasonable period – say five years – the MED could review the situation and if the culture has not changed sufficiently towards charities filing high quality financial statements then the legislative compulsion that is now proposed in the DP could be imposed. There have been changes to the culture in New Zealand, such as smoking cigarettes indoors, that were implemented by voluntary compliance, education, and gently increasing pressure, which seems much more effective than sudden and heavy legislation. In this case legislation can be enacted later if other methods fail to change the culture.

Question 4: should large charities be required by legislation to have an assurance engagement completed?

It appears that the answer is “yes” but the real issue is establishing the border between “large charities” and other charities. This submission, in answer to the previous question, suggested that legislation require an audit for Tiers 1 and 2 charities (with annual operating expenses above \$2 million), and making other changes designed to cause a culture change in the charities sector. After a trial period and a review, that limit may be reduced to the levels proposed in the DP.

Tables 3 and 4 in the DP indicate that about three quarters of charities where annual expenditure is over \$500,000 file audited financial statements and comply with their own Constitution in that regard. Therefore, if the border were lowered to \$500,000 such legislative requirement would not put a big additional burden on the majority of charities. It may make some larger charities improve the quality of their financial statements and meet GAAP. This submission endorses the conclusion in the DP that

“some large charities will not obtain assurance unless forced to do so. The Ministry’s preliminary view is that, in the interests of promoting higher quality GAAP-compliant reporting, large charities should be required by legislation to obtain assurance.”

In this context, size is the only criteria considered in the DP. Size is important as the bigger the charity the more funds are at risk if they are not accounted for properly, and a big charity should be able to afford an auditor. But, another criteria is the source of the charity’s funds: if a charity solicits donations from the public with little or no direct exchange in return then there is public interest in the net proceeds from that activity. Therefore, such charities should be required by legislation to have an audit assurance completed.

Question 5: Assuming that mandatory assurance was to be introduced for large registered charities, should (a) all large registered charities are required to have an audit completed or (b) ‘less large’ charities are required to have an audit or a review completed and ‘more large’ charities are required to have an audit?

This submission supports (a) and disagrees with option (b). Reasons that support the view that favours option (a) are:

- Simplicity – the new law should be easy to learn, remember, and apply; whereas the two-step and optional assurance regime proposed in (b) is complicated, will cause confusion, and is difficult to apply and enforce.
- Fewer borders – under (a) there is one border between large and other charities, but (b) has another border between “more large” and “less large” charities, so border problems double. The problems with such borders are: charities near a border crossing the border both ways over a few years, manipulation to make the charity appear to be on the side of minimum assurance, and the treatment of amalgamations or de-mergers.



- Reviews are not popular and not well known according to the DP. Therefore the proposal in (b) seems to treat “less large charities” as a test guinea pig for the review assurance alternative. The legislation should fix a problem and not undertake an experiment.
- Audit is the best form of assurance and should be the default position for large charities. This submission endorses those statements in the DP.
- If the threshold for “large charities” is set at a high level then a small number of charities would have an audit and should be able to afford an audit, as well as most benefiting from having an audit carried out. For example the high level could be annual expenditure of \$500,000 that according to Table 8 in the DP would mean 2,477 charities are “large charities” that require an audit; and if the expenditure level were raised to \$1 million then there would be 1,464 “large charities”.
- The CC or MED should actively police, and enforce compliance, by charities with their own Constitutions as regards any requirement to have assured financial statements. Such enforcement would improve the quality of financial statements of charities of all sizes because according to Table 4 in the DP about one quarter of charities in every size-band failed to comply with their own Constitution. It may not require any legislative amendment, it would improve the charities’ culture regarding accountability and providing high quality financial statements, and it is targeted at the one quarter who are non-compliers.
- The argument that some charities should be entitled to choose a cheaper option seems spurious. Charities are accountable for the resources they control, and discharge that obligation by filing their audited financial statements in the public arena, **regardless of the cost of audit.**
- Charities discharge their obligations of accountability to the general public by filing audited financial statements. A large charity has a large amount of funds and other resources (some of which may have been raised by soliciting donations from the public), and therefore has a significant obligation to properly account for those resources. Therefore this submission supports the view in (a) that it should be mandatory for all large charities to have an audit completed.

The DP considered the UK approach of an independent examination; but concluded that it should not be adopted in NZ because of the cost of regulating the 30-40 examiners in NZ. However, the independent examiners are specialists in reviewing the accounts of charities, whereas NZ relies on generally qualified accountants, which may be part of the problem. Charities have special activities such as volunteer workers and donated goods and services that may be outside the experience of a qualified accountant in the commercial world. The specialist independent examiner would add value to the financial statements of charities.

Question 6: 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?

This submission accepts the measure of size in the DP, which is the annual operating expenditure; and agrees with the reasons in the DP for that conclusion.

However, another category mentioned by the XRB working group on SFR is charities that solicit donations from the public. It seems appropriate to require audit of financial statements from the following categories of charities:

- Where annual operating expenses exceed a certain amount such as \$1 million, OR
- Where the charity solicits donations from the public.

Question 7: Do you prefer Option A, Option B (noted below) or another option in relation to assurers' qualifications?

**Option A:** A combination of (i) a higher proportion of registered charities being required to have an assurance engagement completed and (ii) certain non-accountants being permitted to carry out relatively simple engagements; or

**Option B:** A combination of (i) a lower proportion of registered charities being required to have an assurance engagement completed and (ii) requiring all of those engagements to be carried out by qualified accountants.

As noted in the DP: the tiered approach in option A would be required if assurance was required for all charities with annual operating expenditure of \$50,000, but all assurance could be done by qualified accountants if the border were raised to \$500,000. The DP reviewed the tiered approach used in England and Wales based on gross income (or in one case income and total assets), and in New South Wales based on fundraising income. This submission agrees with the conclusion in the DP supporting option B and the following reasons from the DP:

- Consistency with section 199 of the Companies Act 1993, but in order to ensure the auditor's independence the auditor should not be part of the management committee of the charity.
- Qualified accountants are trained in preparing, interpreting, and auditing financial statements. Although some non-accountants may be able to conduct an assurance engagement, others may not, and it is difficult to distinguish between the two categories of non-accountants.
- Where the government authorises a person with a certain qualification to perform the assurance engagement then society assumes that they can do it properly – so the legislation should require that the auditor is qualified.

- The adverse consequences if the assurance of the financial statements is not done properly are likely to be more serious for funders, donors, and beneficiaries, of larger charities than small or medium sized charities.
- The phrase “relatively simple engagements” in option A is not defined but in the DP it is linked to the size of the charity and in both the overseas examples in the DP the size, as measured by the income of the charity. Sometimes the financial statements of larger charities are easier or simpler to audit or review than those of small charities because: they are based on better accounting records, prepared by professional and proficient staff, and using reliable internal control systems. Therefore in order to consider or implement option A it must be clear what are “relatively simple engagements” – which is not always related to size.

Question 8: Our views on the proposal for all registered charities with annual operating expenditure of \$300,000 or more to have an audit completed and annual operating expenses of \$200,000-\$300,000 to have a review or an audit.

This submission disagrees with that proposal for the following reasons:

- The objective is to bring about a culture change within charities so that they will file financial statements of high quality, GAAP compliant, and reliable. The most effective way to achieve such a culture change is to encourage voluntary improvement and gently increase pressure to comply, instead of major legislative compulsion. Therefore, the first change may be to: require audit for Tiers 1 and 2 charities (where annual operating expenses exceed \$2 million), the SFR standard applies to the remaining charities, the XRB would educate charities about how to use the SFR templates, and the CC would actively police cases where charities filed financial statements that were not audited or reviewed, contrary to their own Constitution. After a reasonable period – say five years – MED could review the situation. If the culture has not changed sufficiently towards charities filing high quality financial statements then the legal compulsion proposed in the DP could be imposed. Other culture changes in New Zealand were implemented by voluntary compliance, education, and gently increasing pressure, which seems much more effective than legislation in the context of charities.
- The \$300,000 border proposed in the DP is too low. It appears that the border for “larger charities” that are required to have their financial statements audited should be \$2 million to be consistent with the tiers established by XRB. This question of the lower limit for a “large charity” is a matter of judgement, but it should not be below \$500,000. As noted above if the border were \$500,000 then according to Table 8 in the DP it would mean 2,477 charities are “large charities”; and at \$1 million then there would be 1,464 “large charities”.

- The CC or MED should actively police, and enforce compliance, by charities with their own Constitutions as regards any requirement to have their financial statements assured. Enforcement would improve the quality of financial statements of charities of all sizes as according to Table 4 in the DP about one quarter of charities in every size-band failed to comply with their own Constitution. It may not require any legislative amendment, it would improve the culture of charities regarding accountability and providing high quality financial statements, and it is targeted at the one-quarter of charities who are non-compliers.
- Simplicity – the new law should be easy to learn, remember, and apply; whereas the two-step and optional assurance regime proposed is complicated, will cause confusion, and is difficult to apply and enforce.
- There should be one border between large and other charities. This proposal also has “more large” and “less large” charities, so there are two sets of border problems. The problems with such borders are: charities near a border crossing the border both ways over a few years, the treatment of amalgamations or de-mergers, and manipulation to make the charity appear to be on the side of minimum assurance.
- Reviews are not popular and not well known according to the DP. Therefore this proposal seems to treat “less large charities” as a test guinea pig for the review assurance alternative. The legislation should fix a problem and not undertake an experiment.
- It seems heavy-handed to move from the present situation where there is virtually no requirement for charities to have their financial statements audited or reviewed, to require such assurance by law. The DP does not mention what the penalties are for non-compliance with the proposed legal requirement, or whether that legal requirement will be policed. For instance: a non-compliant charity may be removed from the register, its officers may be fined or imprisoned, or the new law may not be policed and non-compliance have no adverse consequences for the charity or its officers. Where a law is not enforced (not policed and without penalties for non-compliance) it is generally bad law.
- The DP states that poor quality and unreliable financial statements are the problem that this proposal will fix, but this proposal relies on the annual operating expenses to accurately define the borders. Either the financial statements are unreliable, **or** they can be relied on to show the actual operating expenses of the charity. This proposal is a paradox.
- It is not clear how this proposal would work along with other parts of a charity’s environment. Other relevant and related factors include: the new SFR standard expected from the XRB, the Constitution of the charity that often provides for the financial statements to be audited, and specific audit requirements that a charity may have agreed to as a condition of receiving funds from a donor. This proposal may result in unnecessary duplication of the assurance of financial statements.

- This submission endorses the conclusion in the DP that “some large charities will not obtain assurance unless forced to do so. The Ministry’s preliminary view is that, in the interests of promoting higher quality GAAP-compliant reporting, large charities should be required by legislation to obtain assurance.” But as noted above the \$300,000 border between large charities and other charities proposed in the DP is too low.
- The XRB working group on SFR mentioned another category: charities that solicit donations from the public. It seems appropriate to require audit of financial statements from the following categories of charities:
  - Where annual operating expenses exceed a certain amount such as \$1 million, OR
  - Where the charity solicits donations from the public.

Question 9: Do you consider that there should be a mechanism to increase the dollar amounts from time-to-time to counter the effects of inflation?

Near the end the DP states “It will be necessary to increase the amounts from time to time due to inflation” but does not provide any detail of the mechanism that it had in mind. Obviously the amounts need to be reviewed to ensure that in real terms the border between large and other charities is unchanged. Such review of those amounts every 10 or 15 years may result in the amounts in the legislation or regulation being amended accordingly.

That procedure would be consistent with the legislative practices in other border amounts, such as those that apply to goods and services tax. This submission does not support making that mechanism automatic, such as indexing amounts to the consumer price index and adjusting it on a certain day each year. Such a creeping mechanism would make it more difficult to administer and apply the provision, than if the amount of the border were fixed for a reasonable period.

Question 10: Our views on the Ministry’s estimates of costs and benefits?

The estimated costs of audits noted in Table 8 in the DP seem to be more than we expect to pay. For example a charity on Auckland’s North Shore with annual operating expenses of \$230,000 provided for audit fees of \$1,500, but in Table 8 the estimated cost is in the range of \$3,250 to \$3,500. The MED estimates of cost did not allow for charities that have an audit performed without any cost or at an amount that is well below what is usually charged in the market. In practice many charities have an “honorary auditor” and some reasons for the audit being voluntary may include: the charity is regarded as a worthwhile cause, the qualified accountant is retired or a friend of someone on the management committee, or an accounting firm does some community *pro bono* work.

This submission agrees with the comments in paragraph 59 of the DP that beyond annual expenditure of \$400,000 the cost of assurance tends to vary quite significantly from entity to entity depending on the nature and complexity of the charity's operations. Similarly, this submission endorses the comment in paragraph 60 that

“smaller charities pay less in dollar terms but more in proportion to their size for the following reasons:

- a. The fixed costs of planning an assurance engagement;
- b. The assurance risks (e.g. the quality of the entity's accounting systems) are often much greater for smaller entities.”

It seems virtually impossible to quantify the amount of the benefit of having reliable and high quality assured financial statements. The reputation of a charity is one of its most valuable assets: for instance at a recent workshop by the CC on fraud the presenter commented that an allegation of fraud can damage a charity's reputation and severely limit its ability to raise funds. By contrast, in the commercial world it is possible to measure the loss resulting from relying on poor quality financial statements – such as investors in finance companies who expected to earn a certain return but lost their investment. Therefore it is difficult to agree or disagree with the view in paragraph 64(b) of the DP that:

“the users of the financial statements would obtain \$1 or more of benefit from assurance for every \$110 of operating expenditure incurred by those 1,500-1,600 charities.”

Figure 1 in the DP uses tricky statistics to persuade rather than inform. The DP has only one graph (so there is no Figure 2) and the graph is the only place that uses a colour in the DP. The graph purports to show “Assurance costs as a percentage of operating expenditure” for a range of expenditure between \$200,000 to \$1 million. The misleading aspects of that graph are:

- The percentages are based on estimates of the average cost of assurance but as the graph does not use the words “estimate” or “average” the reader may assume it is based on actual costs.
- The bar graph shows those percentages on expenditure of: \$200,000, \$250,000, \$300,000, \$400,000, \$500,000, and \$1,000,000, but the gap between each bar appears to be identical. This means that the space representing the \$50,000 between \$200,000 and \$250,000 is the same as the space representing the \$100,000 between \$300,000 and \$400,000 and the same as the \$500,000 between \$500,000 and \$1,000,000.

This graph is visually appealing, but unreliable and misleading.

Question 11: 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?

It appears that the answer is “yes” but the real issue is whether the law should encourage the switch from an audit to a review. This submission is that the law should not be amended to encourage some charities that are currently having an audit carried out to switch to a review, for the following reasons:

- Audit is the best form of assurance and should be the default position for large charities. This submission endorses those statements in the DP.
- The law should encourage best practice, instead of encouraging a switch to a cheaper and inferior form of review.
- Reviews are not popular and not well known according to the DP. Therefore this proposal seems to treat “less large charities” as a test guinea pig for the review assurance alternative. The legislation should fix a problem and not undertake an experiment.
- The objective is to bring about a culture change within charities so that they will file financial statements of high quality, GAAP compliant, and reliable. It seems that the most effective way to achieve such a culture change is by creating an environment toward improvement and gently increasing pressure to comply, instead of major legislative compulsion. Therefore, the first change may be to: require audit for Tiers 1 and 2 charities (where annual operating expenses exceed \$2 million), the SFR standard applies to the remaining charities, the XRB would educate charities about how to use the SFR templates, and the CC would actively police cases where charities filed financial statements that were not audited or reviewed but the Constitution of the charity required that they should be audited or reviewed. The legislation for a review requirement is unnecessary in such a scenario to effect a culture change.
- It appears that introducing a review requirement into law to encourage some charities that are currently having an audit carried out to switch to a review is an abuse of the legislative process. The government should legislate for the environment within which charities operate, but it is an abuse of power for the government to enact laws to encourage charities away from audits and into the cheaper review option.
- Some charities have Constitutions that require their financial statements to be audited. The law should respect that decision by the members of the charity that is reflected in their Constitution, instead of encouraging them to switch to the inferior and cheaper assurance option.
- If accountants, reviewers, or auditors, wish to advertise their services they may choose to do so; but the proposal to introduce a review requirement into law to encourage some charities that are currently having an audit carried out to switch to a review seems to reduce such a law to a government sanctioned, and taxpayer funded, advertisement.

Question 12: Do you have any other comments? Yes, see below:

**Culture change in the charities sector:** The proposal in the DP seems a heavy-handed approach to encourage charities to change their financial statements to be high quality, GAAP compliant, and reliable. It seems that the most effective way to achieve such a culture change is by creating an environment toward improvement and gently increasing pressure to comply, instead of major legislative compulsion. Therefore, the first change may be to: require audit for Tiers 1 and 2 charities (where annual operating expenses exceed \$2 million), the SFR standard applies to the remaining charities, the XRB would educate charities about how to use the SFR templates, and the CC would actively police cases where charities filed financial statements that were not audited or reviewed in contravention of the Constitution of the charity. After a reasonable period of say 5 years the MED could review the situation.

**Cost of compliance in the charities sector:** The DP seemed to focus on the cost of audit or review, and whether charities can afford these assurance costs. But it failed to mention whether there were compliance costs met by the CC or the MED that will be saved if the proposal in the DP to compel charities to increase their own assurance is enacted. It is possible that this whole exercise is designed to shift costs from government agencies such as MED and the CC to charities. The government should bear the costs of regulating the environment within which charities operate. In this context a government agency should police and enforce compliance with the law and the Constitution of the charity, but the charity must arrange and pay for the appropriate audit or review.

**Why is the change proposed now?** This change to the assurance regime for financial statements of charities seems related to the new SFR standard that the XRB is expected to issue shortly. Both measures are intended to improve the quality of the financial statements of charities – but it is unclear why they are not introduced together, as one package. If the assurance proposals in the DP are implemented **after** the SFR then there will be twice as much dislocation within charities sector, and often volunteers prepare and audit the financial statements. If the assurance proposals were **held in abeyance** (except for the requirement to audit the financial statements of charities in tiers 1 and 2 where expenses exceed \$2 million) for say 5 years then it would be easier to evaluate the need for more assurance **after the SFR** regime is implemented and settled down.

**Increasing costs for charities affects people who most need help:** Many charities use their resources to help the most vulnerable people in our society. They raise funds and spend them to help many in our community who are not in a position to help themselves. Therefore the proposal to increase assurance costs of some charities will affect the ability of those charities to assist their clients. Essentially this proposal will indirectly add to the burdens of those people in this country who are least well off and least able to pay more.

**Executive summary in DP includes new material:** Normally it is a summary of the main points in the body of a paper; but the DP executive summary includes new facts and arguments not covered in the body of the DP.



**Financial statements of charities are not as bad as the DP described:** The DP stated that Dr Sinclair observed “many instances of poor quality financial statements prepared by accountants, which resulted in meaningless financial statements that did not tell the story of the charity” and that a benefit of the new SFR from the XRB is to address the “widespread non-compliance with GAAP by registered charities at present”. As noted above that assessment is harsh, unfair, and inconsistent with our observations and experiences of charities. There is room for improvement, and the standards being developed by XRB should result in better quality financial statements published by charities. A consequence of the DP over-stating how bad the financial statements are is that it exaggerates the problem and supports the view that there is a compelling case and urgent need for the increased assurance legislation that is proposed in the DP.

**Charities should publish information that the public require:** The DP looks at whether the financial statements comply with GAAP. Instead of that narrow focus the working party of the XRB on SFR proposed an integrated report of both financial and non-financial information, and also proposed that where a charity raises funds from the public it should disclose the net proceeds raised to meet strong public interest in that activity. The non-financial information includes a simple narrative statement providing an overview of the charity (including the use of volunteers and an indication of quantity), description of its outcomes, and its outputs. Such information in the integrated report should be subject to audit assurance so that the public can rely on this extra information. Unfortunately the DP did not consider the question of what information charities should provide, or the public needs to know, or whether that information is assured.

**Dishonesty and charities:** The DP refers to Dr Sinclair’s descriptions of several ways that accountants use to manipulate financial statements to make charities appear to be poorer than they actually are, and that “such practices might be at risk under section 260 of the Crimes Act 1961, which relates to false accounting”. Recently Parliament unanimously passed an amendment to the Fair Trading Act 1986 that according the NZ Herald of 28 June 2012 “will impose a requirement on professional fundraisers acting on behalf of charities, who keep more than half the money collected in fees, to disclose the percentage retained.” Although the vast majority of charities and the people associated with them are honest and perform worthy functions with complete integrity, there is a dishonest minority. If that minority is not brought to account then their activities will adversely affect the reputation of all charities, and their ability to raise funds. Therefore the right response to such problems is for a government agency such as MED or the CC to review the financial statements, integrated report, complaints, and any other activities of charities, and to refer such cases to the Police or SFO for them to prosecute or penalise the offenders. An inappropriate response to this problem is to impose increased audit or review on all larger charities, as it is likely to create a false sense of security that the problem is resolved.

**Thank you for this opportunity to comment on the proposal.**

Stephen Barker, Treasurer, for North Shore Budget Service 10 July 2012.