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

By email: financialreporting@med.govt.nz

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

Thank you for the opportunity to submit our views on the Ministry of Economic Development's (MED) Auditing and Assurance for Larger Registered Charities Discussion Paper (Discussion Paper).

PricewaterhouseCoopers (PwC) supports the initiative undertaken by MED to review the role and relevance of assurance in developing an appropriate and proportionate accountability framework for registered charities, including as relating to larger registered charities.

In this context, PwC supports the effort to develop an understanding of the relative benefits that may be derived from using different available types of services of an assurance nature or otherwise. Building that understanding is critically important to enabling sound and informed decisions by entities in this sector about service selection suited to charities of different sizes and circumstances.

Public confidence is fundamentally important to the survival and growth of the charitable sector in New Zealand. PwC therefore also applauds the initiative where effort is being devoted to an examination of available alternatives with a view to developing a framework of assurance and non-assurance services that can be applied by charities of different sizes, circumstances and economic impact. Such a framework would improve their decision-making in the area of service selection affecting their ability to achieve the appropriate level of financial accountability. We believe it is important that the sector embrace the opportunity that this consultation represents to take a step forward in establishing a sound and clearly understandable infrastructure conducive to promoting the aims of accountability and stewardship among charities, and most particularly for larger charities.

Independent assurance is an important tool in creating that infrastructure. It is crucial, however, that the accountability and reporting framework that is adopted should strike the right balance between improving the quality and reliability of reporting through financial statements, without imposing undue compliance costs upon charities that may potentially outweigh the actual or perceived benefits to be derived.

PwC is New Zealand's largest firm of chartered accountants. The firm has 7 offices in New Zealand and more than 1,200 partners and staff, and is part of the global network of PricewaterhouseCoopers firms. Our practice as chartered accountants gives us extensive experience of all aspects of the financial reporting and assurance regimes in New Zealand.

PwC is pleased to present its submissions on the questions raised in the Discussion Paper. These are set out in the attached appendix.

Yours sincerely

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Appendix A

Specific comments

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

The problem definition in the Discussion Paper extensively references adverse findings cited in an investigation into the observed level of compliance with their legal obligations by registered charities in New Zealand in respect of the preparation of financial statements. These comments largely reflect the failure to prepare financial statements that comply with generally accepted accounting practice in New Zealand (NZ GAAP).

The problem definition also appears to adopt the same perspective as that purportedly undertaken in that research, which attributes those failures to deficiencies in the capabilities of "accountants employed by charities" who are involved in preparing financial statements for charities in the course of their employment. If the role of those employed accountants is a central element of the problem definition, then the wider context of their role must also be acknowledged as being a part of the problem definition.

While we make no comment on the research undertaken, we submit that as a factual reference it would need to be clear in the problem definition that the responsibility for preparing financial statements, or other types of financial information that a charity is required to provide, in compliance with applicable legal requirements (including compliance with NZ GAAP, where applicable) is a fundamental responsibility of the party or parties who manage a charity, and ultimately the responsibility of its governing body. Whilst they may employ accountants to provide assistance in discharging that responsibility, they are not permitted to delegate that responsibility to those accountants. The problem definition may lead to the misinterpretation that such delegation is possible when it is not.

Accordingly, we submit that it is essential that the responsibility for preparing financial statements in compliance with the applicable legal requirements be accurately described in the problem definition. Such clarification is important because, if the problems highlighted by the research exists as reported, then the likelihood must be acknowledged that those problems exist as much due to a weakness in the capabilities of those who have the responsibility for the management of the charity to properly discharge the responsibility to prepare financial statements in compliance with the applicable legislation, and a weakness in vigilance exercised by the governing body of a charity in its role of oversight of the charity's financial reporting.

These considerations are of fundamental importance for all registered charities, and most particularly for larger registered charities which are the subject of the Discussion Paper.

Recommendation:
We recommend that the problem definition be redrawn with appropriate reference to the obligations of the management and governing bodies of registered charities, for a more balanced presentation of the causes of the reported problem of registered charities providing financial statements that are non-compliant with the required basis of preparation.

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

The Discussion Paper states that its primary objective is "to find an appropriate balance between the benefits associated with increased quality and reliability of financial statements if they have been assured and the additional costs associated with having the assurance engagement completed."

We agree that the application of the mechanism of independent assurance to financial reporting by registered charities should have the outcome of influencing the quality and reliability of financial statements of those entities. However, we believe that it needs to be clearer that the influence of the independent assurance function is a second order effect on the quality and reliability of financial statements.

In line with our comments above on the problem definition, we believe the stated objective of the Discussion Paper needs to be extended to encompass due consideration of the impact of the quality of management and governance in registered charities, that being the primary factor which influences the quality and reliability of financial reporting by those charities.

The application of an independent assurance mechanism to the financial statements prepared by management provides an external signal about the quality of those financial statements in respect of their compliance with the basis of preparation specified in those financial statements (ordinarily the required basis of preparation set out in the applicable law or regulations applicable to the entity). The independent reporting provided by the assurance practitioner or auditor serves as a mechanism for the users to become aware of the situation where the financial statements are not compliant with the stated basis of preparation, or with that specified in relevant legislation. That information is presumed to be relevant to the users in making decisions in the course of their interactions with the entity.

We caution against framing the problem definition in a manner that implies a causal link between the quality and reliability of financial statements prepared by a charity, and the application of independent assurance as a tool to monitor the quality of the financial statements, but takes no account of the responsibility that management and the governing body are intended to apply to achieve that outcome. If management and the governing body are deficient in their responsibility to ensure compliant financial reporting, then the independent assurance report is intended to signal that assessment to users.

Accordingly, the application of independent assurance serves to highlight non-compliance to users. The application of independent assurance to financial reporting undertaken by entities in regulated sectors, such as registered charities, serves as an incentive for management and the governing body of an entity to be so organized as to be able to discharge their responsibility in respect of the financial reporting undertaken for the charity, and in a manner that will not attract the negative signal of a qualified assurance report.

Recommendation:
We recommend that the primary objective of the discussion be restated to more accurately describe the intended linkage between the goal of achievement of the quality and reliability of financial statements and the application of independent assurance. For example, the objective could be restated as follows:

> *"to identify the appropriate balance between the benefits associated with the incentive established through application of the independent assurance function to the financial statements of a registered charity (i.e. for the management and governing body of the charity to achieve the desired level of quality and reliability of the financial statements they are responsible for preparing for the registered charity), and the incremental costs to the registered charity associated with being required to obtain an external, independent assessment of the quality and reliability of those financial statements."*

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

We have two concerns around the presentation of the available options. Firstly, the options presented are in our view incomplete. They exclude reference to the use of a compilation engagement, widely recognized as an important service relevant for smaller entities to address the area of difficulty described in the problem description set out in the Discussion Paper.

This form of professional service, performed under internationally recognised standards,[1] is particularly relevant for types of entities where management and the governing body are unlikely to

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[1] [1] International Standard on Related Services (ISRS) 4410 (Revised) *Compilation Engagements* (available at: http://www.ifac.org/sites/default/files/publications/files/B012%202012%20IAASB%20Handbook%20ISRS%204410%20(revised).pdf)

themselves have the competency and capability to prepare financial information to the requisite standard set out in applicable law or regulation. This is often the case for smaller entities required to prepare NZ GAAP compliant financial statements, where largely due to the size of the entity, the investment in resources to provide that capability is lacking.

The compilation engagement is not an assurance service, and cannot be described as such. However, the involvement of a professional accountant in the performance of the services serves to enhance the quality of the financial statements prepared by management. The relevant standards for these engagements hold the professional accountant accountable to ethical standards of competence and due care, and also specify a required level of performance. Users of financial statements of charities where this type of service is provided (signalled through the issuance of a report by a professional accountant that describes the nature of the engagement performed) may derive comfort from the fact that management has obtained this form of professional service, albeit that there may be no requirement to obtain independent assurance for the financial statements.

The relative advantage of this approach is that it enhances accountability through directly improving the quality and reliability of unaudited financial information, in a cost effective manner.

In the United Kingdom, the Professional Oversight Board for Accountancy published a report in 2006 which summarised research that "suggested that other users, particularly individuals and companies who are considering doing or are already in business with unaudited small companies, do have an interest in assessing the reliability of financial accounts. However, in the absence of an audit, there is not usually any visibility as to the involvement of professional accountants in the preparation of accounts." The production of an independent compilation report, attached to the financial statements, would provide this visibility and enhance the reliability of that unaudited financial information.

Secondly, we have a concern that in presenting the possibility for certain charities to obtain independent assurance in either the form or an audit or a review there is significant scope for misunderstanding, most particularly on the part of users of financial statements for which independent assurance is required.

We believe that a clear understanding of the nature of each type of assurance is an important factor in the decision to use one type of assurance versus the other. In our experience there is significant risk for the differences between these types of assurance to be overlooked, particularly as regards the limitations that are associated with the review compared to the audit.

As the Discussion Paper notes, the fundamental difference is that the review engagement adopts the limited assurance model. That premise, under the relevant assurance standards, rests on the underlying assumption that the assurance provider will be able to obtain a meaningful level of assurance to be able to express a conclusion on an entity's financial statements applying procedures that are limited relative to those undertaken for an audit.

Applying the standards established for review engagements, the appropriateness of using the review model of assurance is required to be considered by the assurance practitioner, taking account of relevant circumstances, including a range of conditions relating to the entity itself and factors relevant to the entity's underlying ability to maintain accounting records that support the preparation of financial statements. The result of that consideration may, in some situations, be that the assurance provider forms the view that it would not be appropriate to perform a review, and accordingly is required to decline a request to perform a review – notwithstanding that the entity may wish to exercise the option to have a review rather than an audit of its financial statements (or that obtaining a review may be specified under relevant law or regulation).

Recommendations:

1. We recommend that the option of having a compilation engagement be given full consideration as a means of promoting the availability of financial statements of the appropriate quality and reliability for entities in this sector. We believe this form of non-assurance engagement may be suited to some 'less large' or smaller charities, and even if not mandated deserve mention as an available option to achieve an adequate level of accountability through preparation of financial statements – e.g. for smaller charities. [2]

2. If separate options are made available for assurance over the financial statements of larger registered charities, there will be a need for straightforward guidance to be provided that clearly articulates the difference between the different types of assurance service so that an informed choice can be made, where a choice is available, and that users of the financial statements may better understand the level of assurance associated with each form of assurance service. Furthermore, the relevant standards for performing review engagements are an important factor in an entity's consideration of whether the option of having its financial statements reviewed instead of audited, is one that would be appropriate for the entity.

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

It is critical for New Zealand to have an efficient financial market that people have confidence in. Ensuring that a robust framework is developed for the provision of audit, other assurance or non-assurance services for larger registered charities will help support this objective.

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 agree that larger registered charities should be required to have an audit completed, in consideration of the need for larger registered charities to be publicly accountable. We agree that other options should be available for 'less large' charities, such as through having a review where possible under the applicable standards.

We refer to our comments under questions 3 and 4 on the need to developing a framework of available assurance and non-assurance options for charities of different sizes of characteristics. For charities other than large charities (which should be required to have their financial statements audited) such a framework would enable those charities to make informed choices to select the appropriate form of assurance or non-assurance service (or combination thereof) from the range of available options extending from audits to reviews and/or compilations. The availability of such a framework would

[2] Financial statements prepared under a compilation engagement are suited to subsequently being reviewed or audited. For some charities (e.g. smaller charities that lack the resources to be able to adequately prepare financial statements) the benefits that would flow from obtaining this combination of assurance and non-assurance services (including through the increased likelihood of being able to signal the quality of their financial statements to users by achieving a "clean" assurance report), may exceed the combined incremental cost of having both a compilation and a review (or audit, if that is the preferred option for assurance). (For smaller charities that are able to opt out of obtaining assurance for their financial statements, having a compilation performed would typically on its own offer significantly increased ability to provide financial statements of appropriate reliability and quality – albeit that the resulting financial statements are unaudited.)

improve the likelihood that smaller or 'less large' registered charities will be able to select appropriate services in respect of financial statements, and also enhance their ability to adequately demonstrate their financial accountability.

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 the use of annual operating expenditure would be the most appropriate measure of a registered charity's activities, as these are more directly controllable and are more stable over time than annual revenue. Use of this measure would also align the framework with the External Reporting Board's (XRB) proposed tiers for the accounting framework for Public Sector Public Benefit Entities (Tiers).

The XRB has recently issued an exposure draft on the Accounting Standards for Public Sector Public Benefit Entities, which includes a question on whether or not this expenditure should include grants made. It would be appropriate to monitor the outcome of this question to ensure full consistency in the proposed measure, if operating expenditure is utilised.

Consideration should also be given to whether exceptions should be made for those registered charities which do not incur significant expenditure but do manage significant assets. These charities would not necessarily be captured by this measure, yet potentially should be audited to ensure the right stewardship is applied to the assets they hold on behalf of the public.

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

We believe that it is critical to demonstrate that a quality assurance engagement is being performed so as not to undermine the intentions of the framework. This will only be achieved by ensuring that assurance engagements are performed by appropriately qualified accountants and we consequently support Option B. The tiers adopted should be considered closely however to ensure that the costs of the assurance services do not outweigh the benefits for 'less large' registered charities and also that there will be sufficient pool of qualified accountants available to perform the work on a timely basis.

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?

The proposed thresholds do not align with the XRB's Tiers for Public Sector Public Benefit Entities. It would appear inconsistent to permit simple format reporting for entities that have operating expenditure of $2,000,000 or less, yet require a full audit for those with operating expenditure greater than $300,000. The MED should consider whether this distinction in the thresholds is appropriate given the differing users of financial statements for registered charities, who will be concerned with the stewardship of donations, in contrast to other public benefit entities.

We also have concerns that there will not be a sufficient pool of qualified accountants to conduct audits for all registered charities that exceed these thresholds. This may result in sub-standard work being performed either through using less experienced/qualified accountants or through insufficient time being devoted to the audit. This will undermine the intentions of the proposed framework.

It may be more appropriate to legislate for a review or other assurance options for charities below $2,000,000 operating expenditure, rather than require an audit.

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?

Including a mechanism to increase the dollar amounts from time-to-time will help future proof the legislation.

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

The proposed fee ranges do not appear to be credible based upon our knowledge of the base compliance cost for any audit. There is a clear risk that the information used to base the estimates for costs and benefits will likely include work provided pro-bono or at a significant cost reduction and so are unlikely to represent the true cost of an audit. We would have strong reservations over making public proposed costs for an audit as these will vary significantly between registered charities depending upon factors such as the quality of their accounting records, the competency of the preparer and the complexity of any transactions, not just the quantum of operating expenditure. Signifying the cost of an audit may create an unrealistic expectation in the market of the compliance cost to the charity and also limit the number of qualified auditors willing to carry out this work. These factors will potentially result in lower calibre professionals performing the work than anticipated, undermining the proposed framework.

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?

It is appropriate to offer alternatives to audit for 'less large' charities, however we do not believe that review is the only option that should be made available (refer to our comments in question 3).

Q12. Do you have any other comments?

We have no further comments.