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SUBMISSION

In response to the Discussion Paper: *Auditing and Assurance for Larger Registered Charities*

By Dr Michael Gousmett PhD FCIS

Introduction

As a practitioner with over twenty years experience in the charity sector, as CEO, General Manager, author, researcher, and commentator, my submission is based on that experience and my wider knowledge of charity reporting and assurance issues. The issue of auditing and assurance needs to be seen in the wider context of the sector, rather than from a narrow perspective of a prescriptive requirement.

The views expressed are mine and not necessarily those of my fellow trustees of The New Zealand Third Sector Educational Trust.

Question 1: Problem Definition

The major issue is that of identifying the point at which charity is considered "large" in terms of requiring an assurance obligation, as stated at Paragraph 4, or for that matter, "medium-sized" or "small." I do not consider the level of operating expenditure to be the appropriate criteria as described in the Discussion Paper, as the term "operating expenditure" was not defined. In terms of the financial activity of a charity, there are two main classes of expenditure with respect to the Income Statement: Operating Expenditure being the administrative function of the charity; and Charitable Expenditure, being the application of funds to charitable purposes. Including Charitable Expenditure as a part of Operating Expenditure may disguise the fact that more is spent on administration costs, such as salaries, than is applied to charitable activities. This immediately highlights the deficiencies in accounting standards in New Zealand (as referred to at Paragraph 9), unlike in Australia where a sector-specific code of accounts has been created which avoids misreporting of expenditure.[1] The issue for New Zealand then becomes one of defining an appropriate system for the classification of expenditure which I acknowledge is not without its difficulties but, as has been demonstrated in Australia, is resolvable. However financial reporting standards alone, as mentioned at Paragraph 10, will not of themselves resolve the issues.

At Paragraph 16 the XRB is considering how non-financial or qualitative reporting can be integrated into financial reporting standards. Again there is a model overseas that should be considered, that model being the Statement of Recommended Practice (SORP) and its requirement for a Trustee Report as required by the Charities Commission for England and Wales which provides the most extensive reporting anywhere in the world of the activities of a charity,[2] other than the Form 990 requirements of exempt IRS § 501 c (3) entities in North America.

Neither does an audit, or assurance report, necessarily provide the answer. I have seen situations where the audited financial statements of a faith-based charity were seriously deficient and misleading, almost to the point of negligence on the part of the auditor and the chartered accounting firm which prepared the reports. Trustees of charities need to be held to be accountable, more so than they are currently required to be. The lack of knowledge by many trustees of sector-relevant legislation, such as the Charitable Trusts Act 1957, the Trustee Act 1956, and the Charities Act 2005, also borders on being at the least disinterest and at worst negligence. The requirement to provide a Trustee Report ensures a greater degree of evidence that the trustees actually know what they are doing, and how the funds and activities under their guidance are being governed.

It is noted at Paragraph 15 that Rowena Sinclair has observed the practice by some charities of establishing an incorporated society to 'run' a charity with the assets and surpluses held in a separate [unidentifiable] charitable trust. Some charities also set up separate trusts to hold assets in effect off balance sheet, transferring income to the operating trust as required. It is not uncommon for an incorporated society to also be registered as a charitable trust, such as St George's Hospital in Christchurch.[3] As a private hospital the entity has in recent years established a corporate structure of limited liability charitable companies which in turn undertake joint ventures, or associate, with a number of private companies, nominee companies, and trustee companies, with nearly 100

[1] Queensland University of Technology *The Australian Nonprofit Sector Legal and Accounting Almanac 2011*, (March 2012) QUT Standard Chart of Accounts, 4.2 Developments in the Standard Chart of Accounts at 121.
[2] See The Charities SORP 2005 at www.charity-commission.gov.uk.
[3] St George's Hospital Incorporated, Charities Commission Registration CC27015.

individuals holding shares or pecuniary interests in those vehicles.[4] While the Trust Deed of St George's Hospital requires the provision of the altruistic nursing of the sick, there is no evidence available in the public domain that reports such activity. Due to the effects of consolidation the hospital's group financial accounts also fail to tell the full story to the public. The Trustee Report and associated assurance report would assist in overcoming such deficiencies.

Another society with which the author is familiar is also registered as a charitable trust yet the society operates predominantly in the interests of its members, as a club, not for the benefit of the public. The audit reports of these entities do not comment on such activities and there is no immediate way in which members of the public are able to scrutinise the behaviour of these organisations in the absence of detailed trustee reports.

Question 2: Regulation

The primary objective of charity regulation is to ensure that funds entrusted to charities by donors and funders are applied to charitable purposes, and not accumulated as wealth. The creation of wealth is not a charitable purpose. Whilst I have been told by a lawyer, the chair of a charitable trust, that once the funds were in the hands of the trust their use was the business of the trustees and no-one else, I do not hold with that view, as these are public funds for public benefit. I am aware of a faith-based charity which raised funds for the earthquakes in Christchurch which as at June 2011 had retained $500,000 in its head office accounts rather than release the funds to the local charity which needed the funds. Donors do not contribute to such appeals in order that the charity can increase its net worth. Situations such as this highlight another deficiency in charity regulation in New Zealand, the requirement to provide a reserves policy which explains the reasons for investing funds, which may be perfectly valid, instead of applying them to the charitable purposes as described in the entity's trust deed. The audit/assurance and review should be required to comment on such activities. Thus the need for a balance between requiring an audit/assurance versus a review is clear. If a charity is holding funds of a certain magnitude, then they should be required to undertake an assurance engagement, rather than a review. If the charity does not want to undertake an assurance engagement yet holds significant funds, the rationale for the existence of the charity then comes into question. The public, as taxpayers who subsidise the activities of charities through their exemption from income tax and the donee tax credit, have a right to know

[4] As at June 2011. St George's Hospital Limited, Company no. 504714 and CC27014; St George's Hospital (No. 2) Limited, Company no. 1102285 and CC27017; St George's Hospital (No. 3) Limited, Company No. 2005695 and CC27018. The St George's Hospital Cancer Institute is also a registered tax charity, CC26864. See also St George's Hospital Group, CC27012.

that the charity is complying with its trust deed. The charity in turn has an obligation to meet that requirement.

Question 3: Options

New Zealand does not have the scale that is evident in the UK and Scotland in order to have independent examinations. The process should either be an audit assurance, or a review.

Questions 4 and 5: Assurance engagement for larger charities

I am of the opinion that "large" charities should be required by legislation to undertake assurance engagements by way of audit, largely for the reasons in my response to Question 2. A charity is either "large" or it is not. If not, then it will be a medium-sized, or a small charity. There may be times when those thresholds are encroached upon, but if a medium sized charity has clearly moved into the category of a large charity, then its responsibilities to the public and its stakeholder also change.

Question 6: Assurance vs review

I have stated above my disagreement with operating expenditure being the criteria for determining assurance vs review. Ergo, I disagree with the statements at Paragraphs 43 and 44 of the Discussion Paper. By way of example, the Anglican Church Property Trustees in Christchurch hold investments of some $42 million.[5] I do not believe that because their primary focus is the advancement of religion that they should be accorded especial status on the basis of not using assets for economic purpose.[6] These are funds which are of a charitable nature for which a considerable fiscal benefit is provided through the privilege of being exempt from income tax.

[5] Church Property Trustees, Anglican Diocese of Christchurch, Charities Commission Registration No. CC36062 at www.charities.govt.nz.

[6] The author considers that in an increasingly secular society funds used for religious purposes by those who hold particular beliefs should be liable to taxation, in the same way that an incorporated society for the benefit of its members is liable for tax, while funds applied by religious bodies to charitable purposes should be exempt from income tax. In the words of Immanuel Kant [1724-1804] the cost of maintaining ecclesiastical establishments should be borne by the people who profess the particular faith of the church. Should a faith-based charity use funds raised from the public for masses for its deceased members, or for significant anniversaries, while at the same time the members are not required to subscribe to the society? Masses for the dead were held to be a superstitious use and contrary to charity law from as early as the 17th century – (see Duke, *The Law of Charitable Uses* [1676]). Such activities should require the clear separation of funds between those applied to religious purposes in support of the members who belong to the society, and those applied to charitable purposes for the benefit of the public through the operation of the charitable trust.

Further, why should an asset-rich but low-expenditure charity be treated differently from others that choose to apply their funds for which they were intended? This is a form of reverse discrimination.

Question 7: Qualifications

I prefer a mix of Options A and B: That “large” charities should be required to undertake an assurance engagement; that “medium” charities be required to have a review by a chartered accountant; and that “small” charities be reviewed by a person who has professional business qualifications and is also a member a professional body.

Question 8: Operating expenditure criteria

While the studies by Dr Carolyn Cordery and Kapil Patel are of considerable use with respect to this exercise, the results indicate that a more comprehensive study is warranted, given the issues that the Discussion Paper raises. I do not disagree with the study findings as presented. However, the concern should be with the need for an assurance or a review, not the number of charities which will be required to undertake either one or the other or the associated compliance costs. Charities have a responsibility to be accountable, for reasons that I have outlined above, and the cost of a review or an assurance is a part of that responsibility. It is no different than the requirement for small, medium and large businesses to comply with their fiscal obligations with respect to income tax. Apart from the little-understood requirement to regularly self-assess for any potential income tax liabilities, charities do not have those requirements and the cost of a review or audit is small relative to the obligations of the for-profit sector.

Question 9: Inflation

I have alluded to threshold crossover above, and because inflation is a fact of life, any thresholds that are set will need, from time to time, to be reviewed for their appropriateness.

Question 10: Ministry estimates

Further in-depth studies would be of use in this regard, given that once again operating expenditure has been used as the basis for the data in Table 8. The figures appear reasonable in this context, given that the average cost approximately doubles between those with operating expenditure of $100,000 and $500,000, and then between $500,000 and $1m. Given the level of remuneration being paid to some ceo’s of the larger charities, these sums are insignificant to ensure their accountability as well.

Question 11: Audit to review

One would have to question why a charity would prefer a review to an audit, if it has been its habitual practice to undertake an annual audit.

Question 12: Further comments

Annual Review and Periodic Audit

One option I wish to propose is that medium-sized charities have an annual review, with an audit undertaken say every three or five years. This will verify the veracity of the reviews by providing a higher standard of assurance from time to time, while also reducing compliance costs over time.

Thresholds

I have not suggested thresholds for large, medium or small charities, suggesting instead that further work is needed in this regard. While for-profit SME-sector thresholds have been applied as a surrogate in this regard, I do not consider that to be an appropriate surrogate for the charity and wider not-for-profit sector. It may well be time to undertake an update of the 2007 nfp sector report by The Johns Hopkins University, Statistics New Zealand, and Massey University, to ascertain size within the charity sector in New Zealand.[7]

Thank you for the opportunity to comment on this issue.

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[7] Statistics New Zealand (2007), *Non-profit Institutions Satellite Account: 2004*, Statistics New Zealand, Wellington.