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20 July 2012

Auditing and Assurance for Larger Registered Charities  
Competition Trade and Investment Branch  
Ministry of Economic Development  
Wellington

[financialreporting@med.govt.nz](mailto:financialreporting@med.govt.nz)

I attach a submission on the discussion paper, Auditing and Assurance for Larger Registered Charities.

Yours sincerely

Kind regards

A handwritten signature in black ink that reads "D. C. Hay". The signature is written in a cursive style and is positioned above a horizontal line.

David Hay  
Professor of Auditing

## **Submission on the discussion paper: Auditing and Assurance for Larger Registered Charities.**

By David Hay

I am Professor of Auditing at the University of Auckland. I have held that position since 2008, and have had a career in practical auditing and later teaching and research in auditing since 1976.

I have published a number of research articles on New Zealand and international auditing. My research articles included a co-authored paper on the voluntary choice of an auditor of any level of quality by New Zealand incorporated societies<sup>1</sup> and a forthcoming paper on the submissions made on the auditing issues in the 2009 discussion papers by the Ministry of Economic Development and the Financial Reporting Standards Board.<sup>2</sup>

I am involved in professional accounting activities, currently including being a member of the Admissions and Membership Committee of the New Zealand Institute of Chartered Accountants and the Chartered Accountants Australia-New Zealand Education Board established by the Institute of Chartered Accountants in Australia and the New Zealand Institute of Chartered Accountants.

In my opinion there is a need for an alternative form of assurance that provides entities like charities with a second opinion on their financial statement, but is less rigorous and costly than an audit or a review engagement by a chartered accountant in public practice or a licensed auditor.

In the terminology of auditing and assurance, assurance means any activity that improves the quality of financial reporting information, or its context. An audit is a particular type of assurance that includes considering risk, examining evidence, assessing whether the financial report complies with the appropriate financial reporting framework and reporting a conclusion. It is required to be carried out by an independent expert.

I agree that an audit (as defined by the accounting profession) is appropriate for larger charities.

However, there are many cases in which users of the financial statements of charities (and many other community organisations such as sports clubs or other societies) demand an “audit”. The “audit” that they want is not an audit as defined in professional auditing standards, but some kind of audit using the dictionary definition (“an official examination of accounts”). If these community entities attempt to get an audit done, they often find it difficult

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<sup>1</sup> Hay, D., and Davis, D. 2004. The voluntary choice of an auditor of any level of quality. *Auditing: A Journal of Practice and Theory*, 23 (2): 37-54.

<sup>2</sup> Davis, M. and Hay, D. 2012. An analysis of submissions on proposed regulations for audit and assurance in New Zealand. *Australian Accounting Review* 22 (accepted for publication).

to get a chartered accountant who is willing to do the audit; they find that the audit is very costly; and that the report is very complex.

The independent examination described in the discussion paper as used in the United Kingdom seems to be well suited to this situation. The discussion paper argues that the number of entities in New Zealand is not large enough to justify introducing such an alternative, but in my opinion it could be an excellent solution that will allow for not just charities but many community organizations to get some form of assurance that meets their needs.

In the 2004 paper by Hay and Davis, we found that out of a sample of 380 incorporated societies, 80 were not audited and more than half of the remainder were audited by individuals who were not chartered accountants in public practice. Unqualified persons audited 72 of these societies, and individuals with some form of qualification such as a commerce degree audited 87. These audits often did not appear to meet professional auditing standards. Thus there was considerable demand by small entities for some form of assurance at a lower level than a formal audit or review. We found that the choice of a more qualified auditor was associated with entities that were larger, had more debt, and paid more in salaries and wages. It appears that cost-benefit considerations influenced the choices made.

In the 2012 paper by Davis and Hay, we reviewed submissions which showed that many preparers were opposed to the recommendation that they would be required to have a review engagement in place of the informal audits that some currently have.

Thus there is evidence that in New Zealand there is a substantial group of entities who have a need for some form of attestation, but for whom a formal audit or review is too complicated and expensive. Independent examination seems to be a suitable solution that should be investigated further.

I accept that there are dangers, limitations and costs inherent in introducing this form of assurance. But in my opinion it would fit well with the needs of New Zealand charities, and other community organizations.

Responses to the questions in the discussion paper:

<i>Question</i>	<i>Response</i>
1	Agree
2	Agree
3	Agree
4	Agree
5	In my opinion (b) is a good use of review engagements.
6	Expenditure is probably satisfactory. It is not obvious to me which is more volatile for most entities, revenue or expenditure. This issue could be investigated by examining a sample of financial statements.
7	Option A
8	I understand how the levels of expenditure for this requirement are derived. However, in my opinion the levels are too close together. I suggest requiring an audit if expenditure is greater than \$1 million, and are requiring an audit or a review of expenditure is greater than \$400,000.
9	Yes
10	<p>Costs: Costs of an audit or a review are very context specific. In auditing research a regression model using a larger number of variables is generally used, including a constant and measures for complexity, risk and audit firm as well as size. It may be that the figures used are not very good at predicting the cost of an audit or a review for some charities.</p> <p>Benefits: quantifying the benefits of an audit is a very difficult task. The assumption that entities should spend \$1 on assurance for every \$110 of expenditure (nearly 1%) seems to be too high, but it is probably impossible to assess what the benefit of assurance is without taking account of the level of risk that an entity faces and its other corporate governance mechanisms.</p>
11	Possibly.
12	See the body of my submission above.