



**Ministry of Business,  
Innovation & Employment**

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# **AUDITING AND ASSURANCE FOR LARGE & MEDIUM REGISTERED CHARITIES – CONCRETE PROPOSALS**

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**February 2013**

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# Request for submissions

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The Ministry seeks submissions on the proposals described in this paper. This consultation relates only to assurance by entities registered under the Charities Act 2005.

When preparing your submission, please:

- Direct your comments to specific questions, in question order; and
- Provide electronic submissions in both .pdf format (for publishing and filing) and an editable format such as Word (to assist compilation of submissions).

**This will help your comments to be processed, understood and taken into account.**

Please send submissions to:

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

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The last date for submissions is Friday 17 May 2013.

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# 1. Background and proposals

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- 1 In April 2012, the Ministry of Economic Development released a discussion paper outlining tentative proposals for mandatory assurance for registered charities with annual operating expenditure of \$200,000 or more. The purpose of this paper is to outline concrete proposals taking formal submissions and other information obtained from stakeholders into consideration.
- 2 This concrete proposals paper has been written on the assumption that stakeholders are familiar with the issues. Therefore, the background material in the April 2012 paper is not repeated here. Stakeholders should refer to the previous paper, which is on the MBIE website at the link, for descriptions of the status quo and problem, statement of objectives and options:

<http://www.med.govt.nz/business/business-law/auditing-and-assurance-for-larger-registered-charities>

- 3 The revised proposals are:
  - 3.1. To require large registered charities to have their financial statements audited. A charity will be large if its operating expenditure (OPEX) was \$1 million or more for both of the last two financial years.
  - 3.2. To require medium-sized registered charities to have their financial statements reviewed or audited. A charity will be medium-sized if it is not large and its OPEX was \$400,000 or more for both of the last two financial years.
  - 3.3. To only permit audits and reviews to be carried out by persons and firms meeting the qualification requirements in clauses 34-36 of the Financial Reporting Bill that is currently before Parliament (see Annex 1).
  - 3.4. The Department of Internal Affairs would, on a risk basis, monitor compliance with accounting standards that will apply to registered charities from 2015 onwards.

## 1.1 Discussion

### 1.1.1 Mandatory assurance

- 4 Most submitters acknowledged the importance of public confidence to the maintenance and growth of the charitable sector. Some other submitters stated that the forthcoming introduction of accounting standards for charities will raise the quality and reliability of financial statements to the required standard and that assurance is not also needed. However, most submitters agreed with the propositions that assurance contributes to public confidence and that larger charities should be required by legislation to have an assurance engagement completed. Some submitters who made this point also noted that, due to the exemption from income tax, larger charities must have transparency and accountability in their financial reporting and that can only result from having an assurance engagement completed.
- 5 Many submitters who support mandatory assurance for larger charities also expressed reservations about some of the more specific tentative proposals included in the April 2012 discussion paper, for example stating that the proposed dollar amounts for defining “larger” charities was too low. We agree.

- 6 Other submitters commented to the effect that assurance should not be required by statute because it does not verify whether funds are being used for the intended charitable purpose. We agree that financial statements assurance does not serve this purpose. However, there are other benefits. An audit or review provides assurance to users about the reliability of the financial statements, with audit providing a higher level of assurance than review. This promotes individual charity accountability and confidence in the sector more broadly. It also increases user confidence that financial statements prepared by different charities can be compared.
- 7 Another view expressed by some submitters was that assurance decisions should be left to the market. We disagree. The purpose of the financial reporting system is to protect the interests of those who require an entity's financial statements for accountability reasons and/or decision-making purposes but cannot demand them. Those interest groups in relation to registered charities are donors and taxpayers who are, by and large, unable to demand assurance.

### **1.1.2 One or two tiers of assurance**

- 8 The April 2012 discussion paper tentatively proposed a tiered system as follows:
- 8.1. A mandatory audit requirement for charities with operating expenditure of \$300,000 or more.
- 8.2. A mandatory review or audit for charities with operating expenditure of \$200,000 to \$300,000.
- 9 The majority of responses supported a two-tiered approach. Those submitters generally expressed the view that it was helpful for medium-sized charities to have a choice about the form of assurance. However, most submitters within this group stated that the review option band should be much wider than the \$100,000 proposed in the discussion paper.
- 10 Another group stated that there should be no second tier with a review option because they consider that a review is of little value. Unlike an audit, a review does not provide a high level of assurance that the financial statements comply with applicable financial reporting standards. Nor does it include an evaluation of the entity's internal control systems.
- 11 Another group of submitters stated that all large registered charities should be given the option of audit or review.
- 12 We continue to favour a two-tiered approach because a review may better fit the circumstances for charities which have relatively simple operations. We also consider that entity size is a satisfactory proxy for whether the entity is likely or unlikely to have simple operations. We also agree with those who submitted that the audit/review option band should be much wider than that proposed in the April 2012 discussion paper.

### **1.1.3 Non-assurance engagements**

- 13 It was proposed that non-assurance engagements should be treated as options. In particular it was suggested that the following could be considered:
- 13.1. A compilation engagement – The purpose of a compilation engagement is for the accountant to use accounting expertise to collect, classify and summarise information. This ordinarily entails reducing detailed data to a manageable and understandable form without a requirement to test the assertions underlying the information.
- 13.2. An agreed-upon procedures engagement – This type of engagement requires the accountant to report on factual findings in response to set procedures. For example, it might be used to report on whether grants have been managed and spent by the charity in accordance with funding conditions.

14 We accept that such engagements can be useful some of the time. However, financial reporting legislation should not impose any non-assurance engagement obligations. Compilation engagements should not be mandatory because many charities have the internal capacity to prepare financial statements in accordance with applicable accounting standards. The charity's governing board should make that assessment. Funding agencies should decide whether agreed-upon procedures engagements are needed for such purposes as assessing whether grants have been appropriately managed or spent.

#### **1.1.4 Operating expenditure versus other criteria**

15 Most submitters who responded on this issue stated that operating expenditure (OPEX) alone or in combination with another criterion should be used to determine whether a charity is large enough to justify mandatory assurance.<sup>1</sup> About half of all submitters agreed that OPEX alone was the best option. Many noted that OPEX is more controllable and stable over time than income. Some also noted that the External Reporting Board (XRB) is using OPEX for the purposes of determining eligibility for the second and third tier not-for-profit accounting standards and that there are benefits in using the same criterion.

16 Another group of submitters suggested that OPEX be used in conjunction with annual revenue because revenue is used for setting assurance requirements under the Australian Charities and Not-for-profits Commission Act 2012.

17 Another group of submitters considered that a combination of OPEX and total assets should be used to capture charities that do not incur significant expenditure but manage significant assets. Some submitters making this point also noted that OPEX and/or income could allow for the amounts to be understated due to volunteers netting down expenditure with income. However, other submitters, particularly churches, opposed the use of total assets because they tend to not use major assets, particularly land and buildings, for economic purposes.

18 There were also suggestions that income from public donations or government contracts should be used.

19 We retain a preference for using OPEX alone for the following reasons:

19.1. The reasons stated in paragraph 15.

19.2. A single measure is simpler than a one-out-of-two criterion.

19.3. The main purpose of using expenditure and income is the same (i.e. to measure economic activity). Our view is that one or the other should be used, but not both.

19.4. It seems likely that a significant number of charities would have unnecessary assurance obligations if an assets test was to be included.

19.5. Public accountability arises both through accepting donations from the public and the income tax exemption. A measure using public donations would exclude the accountability to taxpayers.

19.6. There is no need to protect the interests of government funding agencies in financial reporting legislation because they can demand whatever form of assurance they consider appropriate. Therefore, government contract income does not target the accountability problem that mandatory assurance would be aimed at.

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<sup>1</sup> OPEX would be defined as total expenses reported in the Statement of Financial Performance in accordance with generally accepted accounting practice.

### 1.1.5 The dollar amounts

- 20 The tentative proposal in the April 2012 discussion paper was that Tier 2 would start at \$200,000 and Tier 1 at \$300,000. We are now proposing \$400,000 and \$1 million. As noted in Table 1, about 3,150 (13%) of registered charities would be subject to mandatory assurance, with 51% of that total in the audit or review tier and the other 49% in the audit-only tier.
- 21 There was no consensus in submissions about the dollar amount. Suggestions ranged from \$25,000 to \$2 million for review and \$100,000 to \$2 million for audit. That said, the majority of submitters proposed amounts that were higher than those we tentatively proposed.

Operating expenditure	Number of charities	Percentage of charities
All charities	25,109	100%
≥ \$50,000	10,125	40%
≥ \$100,000	7,298	29%
≥ \$200,000	4,944	20%
≥ \$300,000	3,844	15%
≥ \$400,000	3,149	13%
≥ \$500,000	2,702	11%
≥ \$750,000	1,961	8%
≥ \$1,000,000	1,556	6%
≥ \$2,000,000	955	4%

- 22 We consider that the amounts should be substantially higher than originally proposed for two main reasons. First, our estimates of assurance costs in the April 2012 discussion paper were understated (those estimates appear on pages 19-21 of the April 2012 discussion paper, which can be found by following the link in paragraph 2 above).
- 23 Our numbers were based on costs of audits which included subsidised work and audits carried out by individuals who do not meet the auditor qualification requirements described in Annex 1 of this discussion paper. There were also concerns that the cost estimates oversimplified the situation and failed to take into consideration such matters as the risks that audit and assurance will cost more if an entity has poor accounting records keeping systems, even if the charity is not large.
- 24 Second, as noted earlier, unlike a review, an audit includes an assessment of the adequacy of the charity's internal control systems. An entity should have four people involved in financial transactions to meet good governance expectations: one with the authority to enter the data, a second to approve the transaction, a third with signing authority and a fourth to check the transaction. Our view is that some charities in the \$300,000-\$500,000 OPEX range could find it difficult to establish and maintain such a system. However, it should be comfortably within the capacity of all charities with OPEX of \$1 million or more.
- 25 Some submitters suggested using the same \$2 million amount for audit that the XRB has adopted to distinguish between Tier 2 and 3 public benefit entity reporting entities. We disagree. It does not follow that assurance costs outweigh the benefits simply because a charity is eligible for simple format reporting. If anything, the opposite is true. A Tier 3 simple format financial report will cost less to audit than a Tier 2 RDR financial report, all other things equal, because there are considerably fewer disclosures to verify. The assurance-related benefit-cost ratio is likely to be higher for charities close-to but under \$2 million than charities close-to but over \$2 million.

- 26 There was general support for the tentative proposal in the April 2012 paper for a mechanism to increase the dollar amounts from time-to-time. Most respondents suggested that this be carried out every 3-5 years. Our view is that 3 years is too short. The average annual rate of inflation has been 2.3% for the last 20 years, which is only 7% over a 3 year period. We consider that 5 years (12%) to 8 years (20%) would be better. In addition, we consider that the number of years should be the maximum time period to elapse since the amounts were last reviewed, not the actual. For example, the amounts could be changed after, say, 5 years, if the maximum was to be 8 years.
- 27 The \$400,000 and \$1 million amounts that were are now proposing also take the following matters into consideration:
- 27.1. The proposal in section 1.1.9 of this paper for the Department of Internal Affairs Charities Unit (DIA Charities) to monitor compliance with accounting standards by registered charities. Although that function would include monitoring audited financial statements, it is reasonable to expect that more monitoring will be needed if fewer charities have audits or reviews carried out.
- 27.2. The approach taken in Australia – The Australian Charities and Not-for-profits Act 2012 also uses a two-tiered approach to assurance, with the equivalent amounts being A\$250,000 and A\$1 million annual income (see section 2 of this paper).

### 1.1.6 Two consecutive years above the thresholds

- 28 It is normal to expect that a charity's expenditure will change from one year to the next. This is not an issue for the purposes of this paper for charities whose OPEX is not close to the proposed \$400,000 and \$1 million thresholds. However, movement in and out of tiers will be an issue for charities reasonably close. Table 2 shows that:
- 28.1. 2.4% of registered charities (1 charity in 41) have expenditure of \$400,000 or \$1 million plus or minus 10%; and
- 28.2. 5.5% of registered charities (1 charity in 18) have expenditure of \$400,000 or \$1 million plus or minus 20%.

<b>Table 2: Registered Charities with total operating expenditure within 10% or 20% of \$500,000 or \$1 million (as at 6 December 2012)</b>		
<b>Operating expenditure</b>	<b>Number of charities</b>	<b>Percentage of charities</b>
All charities	25,109	100%
(a) From \$360,000 to \$440,000	371	1.5%
(b) From \$900,000 to \$1.1 million	235	0.9%
<b>Within 10% ((a) plus (b))</b>	<b>606</b>	<b>2.4%</b>
(c) From \$320,000 to \$480,000	889	3.5%
(d) From \$800,000 to \$1.2 million	483	1.9%
<b>Within 20% ((c) plus (d))</b>	<b>1,372</b>	<b>5.5%</b>

- 29 The percentages of charities that are within 10% or 20% of the proposed dollar criteria are sufficiently high to indicate that a year-on-year assessment is not the best option. We have concluded that a two consecutive years approach should be used. The charity would need to be above the dollar amount for both of the last two years to be in that tier of assurance. For example a charity with operating expenditure of \$390,000 in Year 1 and \$450,000 in Year 2 would be regarded as a small charity and would, therefore, not be required to have an assurance engagement completed. A one year approach would be used for charities that have been operating for less than two years.



30 The XRB is adopting the same approach in relation to its accounting standards tier setting criteria.

### **1.1.7 Exemption issues**

31 Two assurance exemption issues were raised in submissions.

32 First, some submitters stated that charities not receiving funding through public donations or government contracts should not be considered to be publicly accountable and should be exempted from mandatory assurance. We disagree. Our view is that all registered charities are publicly accountable because they are fully exempt from income tax. Our view is that the foregone tax revenue establishes public accountability to taxpayers and the general public. That accountability cannot be met for larger charities without assurance.

33 Second, some respondents whose charity forms part of a group or association of charities raised concerns about the effects of consolidation. They submitted that consideration should be given to whether an exemption can be applied to certain charities with multiple branches.

34 We do not consider that there is a need for such an exemption power. The registered charity will be the financial reporting entity under the XRB's accounting standards. Therefore, only one set of financial statements will be lodged per registered charity. For example:

34.1. If 20 branches are registered separately then each branch will need to lodge financial statements, but there will be no requirement to lodge consolidated financial statements. Assurance will only be required for the branch financial statements if the \$400,000 OPEX test is met in relation to that branch. There will be no assurance requirement relating to any consolidated financial statements that the group of charities might choose to prepare because there will be no lodgement requirement for the consolidated financial statements.

34.2. If there is a single registration for a charity with 20 branches then consolidated financial statements will need to be lodged but there will be no requirement to lodge any branch financial statements. Assurance will be required for the consolidated entity if the \$400,000 OPEX test is met, but no branch financial statements will need to be filed or assured.

### **1.1.8 Auditor qualifications**

35 Most submitters agreed that all charities assurance engagements should be required to be carried out by qualified accountants. The current qualification provisions for statutory audits appear in Annex 1. We confirm that this is our preferred option.<sup>2</sup> There are too many risks that the work will not be up to the required standard if it is not carried out by qualified accountants.

### **1.1.9 Monitoring by the Department of Internal Affairs**

36 NZICA's submission stated that a possible alternative or supplement to a statutory-based assurance regime may be the reinforcement of an in-house DIA Charities compliance capability. This would involve checking compliance with applicable accounting standards using a risk-based approach to determine which returns would be checked. We agree with this proposal.

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<sup>2</sup> MBIE is doing other work to consider the possibility of widening the definition to include members of professional accounting bodies other than NZICA.

- 37 Under the Charities Act 2005, charities are required to file an annual return and attach their financial statements. DIA Charities monitors the returns to evaluate whether the entity continues to qualify for registration under the Act. The current monitoring does not involve evaluation against accounting standards because there are no applicable accounting standards.
- 38 That situation is expected to change. The Financial Reporting Bill, which is currently before Parliament, includes provisions that will require the XRB to make accounting standards for registered charities. The XRB is planning to bring not-for-profit accounting standards that would apply to registered charities into force in 2015, providing that the Financial Reporting Bill is enacted in 2013. We consider that it would contribute to the quality of financial reporting if users know that qualified accountants are carrying out targeted monitoring of compliance with those not-for-profit sector accounting standards. This will be good for the reputation of the sector, and it will particularly benefit the many charities that we anticipate will treat the new financial reporting obligations seriously.
- 39 We also note that clause 77 of the Financial Reporting Bill, which is currently being considered by Parliament's Commerce Select Committee, proposes adding a new financial reporting-related offence provision to the Charities Act 2005. That provision will make it an offence for a charity or an officer of the charity to fail to comply with applicable accounting standards if the entity or officer knew at the time that the financial statements were lodged, that the statements failed to comply with those standards. There should be monitoring to detect such conduct because it is, in effect, financial reporting fraud.
- 40 DIA Charities' resourcing is partly funded by a fee of \$51.10 on charities with annual income of \$10,000 or more. If the Government were to agree to implement the extended financial statements monitoring activity, it would need to be funded from revised levies, which would lead to a modest dollar increase in the average fee. However, DIA Charities would probably take the opportunity to review the levy system, including consideration of replacing the current flat levy with different levies for different sized charities based on operating expenditure.
- 41 Further information about this monitoring proposal appears in Annex 2.

## 2. The situation in Australia

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- 42 The Australian Charities and Not-for-profits Commission Act 2012 was passed on 1 November 2012 and the Commission commenced operations on 3 December 2012.
- 43 The key provisions in the Act relating to assurance are:
- 43.1. A two-tier system of audit for large charities and audit or review for medium-sized charities.
  - 43.2. To require large registered charities to have their financial statements audited. A charity is large if its operating revenue was \$1 million or more.
  - 43.3. To require medium-sized registered charities to have their financial statements reviewed or audited. A charity is medium-sized if it is not large and its annual revenue was \$250,000 or more.
- 44 The key features that we propose for New Zealand are broadly similar. The two-tier approach is the same. The use of revenue rather than expenditure is different. However, revenue and expenditure tend to even out in the long run in the not-for-profit sector. As noted above, we prefer expenditure because it tends to fluctuate less than income in the not-for-profit sector.
- 45 The Australian Treasury stated in its explanatory material for the exposure draft of the ACNC Regulation 2012 that based on Australian Tax Office data, currently 78% of entities registered with ACNC will fall into the small tier, 11% in the medium tier and 11% in the large tier. The equivalent percentages in the New Zealand proposals are 87%, 6% and 6%.
- 46 It is not possible to harmonise the Australian and New Zealand dollar amounts because the two-country exchange rate fluctuates. At the current exchange rate, the Australian dollar amounts are about 30% lower for the lower dollar amount and 25% higher for the higher amount. In addition, the percentage difference between the New Zealand and Australian amounts will change each time the automatic mechanism for changing the dollar amounts in New Zealand is activated (see paragraph 26).

## Questions

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Q1. What are your views on the following proposals in this paper?

- A. An audit requirement for large registered charities
- B. A review or audit requirement for medium registered charities
- C. Use of annual operating expenditure (OPEX) to determine whether a charity is medium or large
- D. Large registered charities – OPEX of \$1 million or more a year for two consecutive years
- E. Medium registered charities – not large and OPEX of \$400,000 or more a year
- F. The two consecutive years test
- G. A regulation-making power to change the dollar amounts in line with changes in the consumer price index, no less than every 8 years
- H. No non-assurance engagement requirements for any class of registered charity
- I. No exemption-making powers
- J. Limiting assurance engagements to qualified accountants
- K. Monitoring of compliance with applicable accounting standards by the Department of Internal Affairs.

Q2. Do you have any other comments?

# Annex 1: The auditor qualification provisions in the Financial Reporting Bill

## 35 Qualifications of auditor

- (1) A person is not qualified to be appointed or to act as the auditor of a specified entity unless—
  - (a) The person is a chartered accountant (within the meaning of section 19 of the New Zealand Institute of Chartered Accountants Act 1996); or
  - (b) The person is a licensed auditor; or
  - (c) The person is a member, a fellow, or an associate of an association of accountants constituted outside New Zealand and—
    - (i) The association is, by notice in the *Gazette*, approved for the time being for the purposes of this section by the Registrar of Companies; and
    - (ii) The person is eligible to act as an auditor in the country, State, or territory in which the association is constituted; or
  - (d) The person, not being a person to whom **paragraph (c)** applies, is—
    - (i) Eligible to act as an auditor in a country, State, or territory outside New Zealand; and
    - (ii) Approved for the time being for the purposes of this section by the Registrar of Companies by notice in the *Gazette*.
- (2) However, if the specified entity is—
  - (a) A person to whom **section 57** applies, a person is not a qualified auditor of the entity unless he or she is a licensed auditor:
  - (b) A public entity under the Public Audit Act 2001, the Auditor-General or any other person who may act as the auditor under that Act is the auditor of the entity (and is the only qualified auditor in respect of that entity).
- (3) **Subsection (2)(a)** is subject to **subsection (2)(b)**.
- (4) None of the following persons is qualified to be appointed or to act as the auditor of a specified entity:
  - (a) A director or an employee of the specified entity:
  - (b) A person who is a partner, or in the employment, of a director or an employee of the specified entity:
  - (c) A liquidator or a person who is a receiver in respect of the property of the specified entity:
  - (d) A body corporate:
  - (e) A person who, by virtue of **paragraph (a) or (b)**, may not be appointed or act as auditor of a related body corporate (within the meaning of section 5B(2) of the Securities Markets Act 1988).
- (5) This section is subject to **section 36**.

### **36 Appointment of partnership**

- (1) A partnership may be appointed by the firm name to be the auditor of a specified entity if,—
  - (a) In the case of a specified entity that is a person to whom **section 57** applies, the partnership is a registered audit firm:
  - (b) In any other case, all or some of the partners are persons who are qualified to be appointed as auditors of the specified entity.
- (2) The appointment of a partnership by the firm name to be the auditor of a specified entity is deemed, despite **section 35**, to be the appointment of,—
  - (a) In the case of a specified entity that is a person to whom **section 57** applies, all the partners in the firm, from time to time, who are licensed auditors:
  - (b) In any other case, all the partners in the firm from time to time.
- (3) If a partnership that includes persons who are not qualified to be appointed as auditors of a specified entity is appointed as auditor of a specified entity, the persons who are not qualified to be appointed as auditors must not act as auditors of the specified entity.

## **Annex 2: Further information on the DIA Charities monitoring proposal**

### **The purpose of Annex 2**

The proposal for DIA Charities to monitor compliance with the forthcoming not-for-profit entity accounting standards was not discussed in the April 2012 discussion paper released by MED. The Treasury has advised us that we should, therefore, include discussion on this issue using the regulatory impact statement (RIS) discussion format. We have not done that in the body of the discussion paper because it would be very inconsistent with the style used elsewhere. The information instead appears in this annex.

### **Status quo**

- Registered charities are required to file an annual return, including attaching financial statements.
- DIA monitors annual returns to check whether entities remain eligible for registration. This does not include checking compliance with accounting standards because there are no accounting standards to govern the preparation of financial statements filed by registered charities.
- NZICA's Code of Ethics states that a member who prepares a set of general purpose financial statements must do so in accordance with GAAP.
- In 2015, the XRB proposes to bring accounting standards that will apply to registered charities into force. Those standards, like all other accounting standards will have the force of law.

### **Problem definition**

- It is very likely that there will be lower levels of compliance with the accounting standards that are scheduled to come into force in 2015 if there is no monitoring.

### **Objectives**

- To promote individual charity accountability and transparency by improving the quality and reliability of information available to users of the DIA Charities register.
- To enhance the reputation of the charities sector as a whole.

### **Options**

The Treasury has suggested to us that there are three practical options:

- a. No compliance monitoring.
- b. Compliance monitoring with a risk-based approach to checking.
- c. Compliance monitoring with all charities having returns checked.

## **Assessment of options**

We consider that Option B is the best because of the following problems with the other two options:

- The level of compliance with any law can generally be expected to be higher if there is a regulator with adequate resources to monitor compliance with the law, correct non-compliance and obtain evidence for enforcement purposes. Under Option A:
  - Users may misinterpret the financial statements that do not comply with the standards.
  - Users may not be able to distinguish between the financial statements that have been prepared in accordance with the standards and those that have not. Other than causing interpretation problems for users, this situation is also contrary to the interests of charities whose financial statements comply with the standards.
- Option C is unlikely to be cost-effective. DIA Charities should focus monitoring activities on high-risk entities such as those that:
  - Develop a history of non-compliance with the accounting standards
  - Have poor governance
  - Engage in significant commercial activities
  - May be accumulating wealth rather than using income for charitable purposes.