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Auditing and Assurance for Larger Registered Charities

Submission to Discussion Paper by Ministry of Economic Development

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We acknowledge and understand the intention of the discussion paper to improve accountability of small non-profits. However, the discussion paper is based on a number of disputable assumptions rather than evidence, and we do not believe that on this basis the Ministry should initiate the legislative process for its proposals. This submission includes the reasons for our concerns about the proposal, and about the suitability of GAAP and present auditing standards for the non-profit sector in general.

1. Is There Really a Problem?

The problem description in the discussion paper is lacking in statistical or empirical evidence. From the summary given it cannot be deduced with any certainty that inadequate accounting practices are widespread in small non-profits.

The paper uses the Charities Register as its almost exclusive source and assumes for the purpose of stating the problem and costing the solution that it is accurate. However, organisations are required to file their Annual Return with the Charities Commission within six months, and many organisations do not have the process of creating financial statements and seeking assurance completed by then. These organisations would upload whatever financial information they have at that date, which is likely not the completed product. We are aware of several organisations that generally do not upload audited financial statements because they are not available at reporting date.

Very few organisations would be able to achieve income of $200,000 or more without accessing monies from funders who require such assurance. We believe that the number of organisations of that size seeking assurance is close to 100%, and that very few of the final Financial Statements contain material errors.

2. Limited Use of Financial Statements in Non-Profits

The paper fails to provide evidence that standardised financial reporting by non-profits actually matters. There is no evidence that Financial Statements are a significant tool for decision making or accountability by Boards, funders, donors or stakeholders. The financial performance and position of non-profit organisations are a secondary consideration for people wanting to invest time or money in them. Their primary consideration is what is trying to be achieved with this investment.

This does not mean that financial information is entirely irrelevant for non-profits, but accuracy is not as essential as it is in for-profit institutions.

Accountability in non-profits is warranted through their stakeholders – the Board members, volunteers and funders. These are predominantly accounting laypeople. It is paramount for financial accountability in non-profits, therefore, that the financial information is easily understood. Accrual accounting, the grants-as-liability concept and many other components of GAAP are not. Professionalising financial reports reduce, not increase, accountability of small non-profits.

3. Limited Suitability of GAAP for Non-Profits

The paper assumes that GAAP is the most suitable standard to be used. Attached in an appendix to this submission are two common examples where GAAP leads to poor results for non-profits.

GAAP and financial reporting standards are based on for-profit entities and they have investors in mind who need to be able to compare between companies. Accounting scholarly literature has, in recent and not so recent years, strongly made the point that accounting standards influence business practice and economic systems overall. Walker (2010), for example, makes the point that introduction of a uniform international accounting standard ignores the fact that there are "varieties of capitalism" (VOC), for some of which the standards are unsuitable. Much of his argument can be applied to the difference between for-profit and non-profit accounting. There is danger that the inherently commercial accounting practices that form GAAP undermine the non-profit model, and therefore the efficiency of the non-profit sector. The non-profit model is not just the for-profit model with an absence of realised profit. It is a fundamentally different way of business.

4. Education versus Forced Compliance

It does not logically follow that monitoring of compliance with GAAP through an assurance process is the solution to the problems the paper perceives. In general, the logical solution for poor accounting practices in non-profits would be education and funding of services that make accounting and financial management help accessible rather than the crude tool of mandating compliance. It is disappointing that the discussion paper has not even considered this.

Present auditing standards, like GAAP, are based on commercial situations: they exist to insure investors about the bottom line of their company. As such they are not a useful tool for non-profits.

Accountability in non-profit organisations is about the 'how', not the 'how much'. Stakeholders in non-profits are not so interested in the financial performance or position of their charity, they are interested in *how* the money is applied. Present audit practice does not include verifying whether the application of funds by the non-profit in question is in keeping with the organisation's own purpose, the purpose the funds were made available for, or their Charities registration. It only verifies numbers. It is not particularly relevant to a non-profit stakeholder whether the organisation has made a $20,000 surplus or a $10,000 deficit, whereas for a business investor such numbers are the key performance indicator.

5. Accountants Lack Non-Profit Qualifications

A further assumption of the discussion paper, that of superior and inferior qualifications of auditors, remains without evidence. No figures have been presented whether non-profit financial statements prepared or verified by the group of professionals preferred by the Ministry are more compliant with GAAP than those prepared or verified by ordinarily qualified accountants or, if it was the case, whether the difference is material.

There is no accounting qualification in New Zealand which requires knowledge or practice in the non-profit business model, accounting, accountability, funding, the structure of non-profit organisations or, in fact, any other aspect of non-profits. All accountants are equally unqualified in this respect. It could credibly be argued that accountants operating in smaller firms with lower charges will be more experienced and therefore qualified in non-profit accounting than those working predominantly with larger businesses or entities, such as the Ministry's preferred group. The paper contains the implication that ordinarily qualified accountants are not sufficiently able to verify the financial transactions or position of a small entity with a turnover of $200,000. If this were the case, any other qualification than that of the preferred group in the paper would be entirely meaningless, and New Zealand's tax base would be fundamentally erroneous.

6. Main Costs of Proposal Not Considered

The Ministry's costing is meaningless, and the paper fails to list a single tangible benefit of the measures proposed other than the academic exercise of producing correctness as defined by a certain standard.

We have already pointed out that the base of the Ministry's assumptions about the problem, the Charities register, is not reliable, and therefore the figure of 1,500-1,700 affected organisation is highly likely to be incorrect.

A probably more important cost factor not mentioned in the paper is that the market which non-profits could use to obtain assurance is proposed to be drastically reduced to all but the most costly options. Not only organisations are affected which, at present, do not obtain such assurance (if, in fact, there are any), but those who obtain such assurance from accountants not in the preferred group.

The overall effect of channelling money away from charitable purposes into the private sector (accountants) via the tool of compliance costs must also be considered. Statistics New Zealand (2007) has calculated that every dollar spent by non-profits creates almost double the economic output, due to volunteer work. Money spent on compliance, however, does not create output and is effectively sunk money. This means that for every dollar transferred from non-profits to pay private accountants another dollar will be lost in economic productivity.

Non-profits generally deal with increased cost without increased funding by cutting employment hours. If we assume the average annual earnings of a non-profit employee to be about $40,000 and the average earnings of a Chartered Accountant or Auditor to be about $120,000, three employment hours are lost in the non-profit sector for each employment hour created in CA firms. A further three hours are lost in volunteer productivity. Increasing compliance costs in the non-profit sector is very expensive business.

The levels from which the new rules are proposed to apply ($200,000/$300,000) seem entirely arbitrary and no evidence is given to support why these figures are suggested. The reasoning seems to be an affordability approach, the cost of compliance versus the return of expected benefit. In this context we note that parliament is expected to abolish the for-profit Tiers 3 and 4 of New Zealand's Financial Reporting Framework, removing any obligation for for-profit entities with turnovers or assets of less than several million dollars to produce any financial reports at all, reasoning that the compliance cost is too high for these businesses (XRB, 2012). It is hard to understand why the cost of creating standardised financial statements is considered too high for commercial entities earning $2m per year, but acceptable for non-profit entities of only one-tenth of those earnings and burdened with the added cost of assurance.

In the absence of hard evidence of any tangible benefit, we therefore believe that Tiers 3 and 4 for Public Benefit entities in the Framework are likewise redundant.

7. Summary

In summary, the proposal is about addressing a poorly documented problem in the non-profit sector with tools designed for for-profits, of which there is no evidence that they work in a non-profit situation, using professionals with not necessarily any training or experience in non-profit accounting or management. The paper's costing of the proposal fails to include the predominant cost factors and is based on probably flawed data from the Charities register.

We therefore submit that the proposal is rejected and that further research is undertaken into the issues highlighted in this submission. We recommend that a genuine collaboration is initiated and undertaken between the accounting profession and non-profit stakeholders to determine adequate standards and practices for non-profit financial accounting and accountability rather than leaving this to a for-profit focused accounting profession, which is inadequately trained in the non-profit business model.

8. References

XRB (2012): External Reporting Board: Proposals for the New Zealand Accounting Standards Framework. Xrb.govt.nz

Statistics New Zealand (2007): Non-profit institutions Satellite Account: 2004. Statistics New Zealand, Wellington.

Walker, M. (2010). Accounting for varieties of capitalism: The case against a single set of global accounting standards. The British Accounting Review, 42(3), pp. 137 - 152.

Appendix: Doubts About GAAP in the Non-Profit Sector

The following two examples illustrate that business-oriented GAAP often yields poor results for non-profits.

Example 1:

An organisation receives $180,000 in operational grants each year and generates $20,000 of other income. At Balance Date, half of the grant money remains unspent. The expenditure was $180,000, all of which could be matched to grants.
The simplified Financial Statements would look like this (differences highlighted):

GAAP[1]		Non-GAAP (Grants as Income)	
INCOME STATEMENT			
Expended Grants	$ 180,000*	Grants	$ 180,000
Other Income	$ 20,000	Other Income	$ 20,000
Expenditure	($ 180,000)	Expenditure	($ 180,000)
Surplus	**$ 20,000**	**Surplus**	**$ 20,000**
BALANCE SHEET			
Bank Accounts	$ 130,000	Bank Accounts	$ 130,000
Grant Liability	($ 90,000)		
Equity	**$ 40,000**	**Equity**	**$ 130,000**

(*This amount is made up of $90,000 carried over from the previous year, and the expended half of the current year's grants).
In the next year *the organisation has a big drop in operational grants and only manages to acquire $130,000. The organisation does not cut back its expenses.*

GAAP[1]		Non-GAAP	
INCOME STATEMENT			
Expended Grants	$ 180,000	Grants	$ 130,000
Other Income	$ 20,000	Other Income	$ 20,000
Expenditure	($ 180,000)	Expenditure	($ 180,000)
Surplus	**$ 20,000**	**Deficit**	**($ 30,000)**
BALANCE SHEET			
Bank Accounts	$ 100,000	Bank Accounts	$ 100,000
Grant Liability	($ 40,000)		
Equity	**$ 60,000**	**Equity**	**$ 100,000**

The Financial Statements using GAAP show an equal financial performance to the previous year, although the organisation has acted somewhat recklessly by not reducing its expenditure. Their Equity figure further improves and so do various analytical ratios. The organisation looks *better* than before, and the reduced grant income will not impact on the Financial Statements before the following year.

Treating operational grants as income (right column) gives a more accurate picture. The reduced grant income is shown in the year it affects and the organisation posts a deficit as expenditure has clearly outstripped money received. The organisation's equity reduces. This statement is more likely to lead to questions from funders or Board members and trigger action from management. Financial statements like these will disappear, however, if auditing by CAs or registered auditors becomes mandatory.

Example 2:

An organisation regularly receives $150,000 in grants, all of which it expends, and $10,000 in other income. This year, however, the organisation receives a donated vehicle for staff, valued at $25,000. The financial performance of the organisation according to GAAP[1] is disproportionally affected:

Income Statement for previous year:

Expended Grants	$ 150,000
Other Income	$ 10,000
Expenses	($150,000)
Surplus	**$ 10,000**

Income Statement for this year:

Expended Grants	$ 175,000
Other Income	$ 10,000
Expenses	($150,000)
Surplus	**$ 35,000**

The donation of the car has a disproportionate effect on the Income Statement according to GAAP: Income has risen by 17%, and the surplus has risen by 350%. The Income Statement suggests that the organisation has performed substantially better than in the previous year, and this may set an unrealistic expectation for a similar result in next year. Without another car donation, the organisation's Statements for the next year will make the organisation's performance look significantly worse than for the current year.

A better reflection of the organisation's financial performance would be to realise the asset directly in equity. The car donation clearly improves the organisation's financial position, but as a one-off event it distorts the Income Statement prepared according to GAAP.

Businesses have to purchase non-current assets with cash from their ordinary revenue as they do not receive extra revenue to purchase such assets, or asset donations. Purchasing non-current assets has no effect on a business's Income Statement.

Cost in businesses is driven by the generation of income. In non-profits, however, the reverse is true: income is driven by expenditure. This fundamental difference in principle gives rise to distortions when business-based GAAP is applied to non-profit accounting.

[1] The relevant accounting standard, NZIAS 20, does not actually apply to Public Benefit Entities such as non-profits, and as such they are free to account for grants as income (as long as the method they use is disclosed). In practice, accountants consistently apply NZIAS 20 to non-profits as well, however, either because they are unaware of the exception to PBEs or because they believe it is simply an application of accrual accounting and leads to greater accuracy.