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Assurance for Larger Registered Charities  
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Dear Sirs

## **DISCUSSION PAPER – AUDITING AND ASSURANCE FOR LARGER REGISTERED CHARTITIES**

Thank you for the opportunity to provide comment on the Ministry of Economic Development's ("MED's") Discussion Paper *Auditing and Assurance for Larger Registered Charities*.

Our comments, which are supported by the WHK New Zealand network of firms, are as follows by reference to the twelve questions raised:

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

We acknowledge as members of NZICA (New Zealand Institute of Chartered Accountants) we are obliged to encourage clients to prepare general purpose financial reports in accordance with GAAP (Generally Accepted Accounting Practice). However, there is a significant expectation gap between the accounting profession's need to prepare GAAP compliant financial statements and the cost versus benefit need of the not-for-profit sector in general.

We agree with the problem identified and that this is particularly relevant in the cases of charities who continue to use the argument that their funds are better spent on directly contributing to the objectives of the charity instead of on GAAP compliance / audit costs. Whilst there is a legal statutory requirement for companies to prepare GAAP financial statements under the Financial Reporting Act 1993, there is not the same legislative requirements for other types of entities.

As a result it is common practice that charities are reliant on their own internal skill sets to produce financial statements or may have engaged with accounting practitioners who have failed to enforce the use of GAAP principles in producing / auditing sets of financial statements on the basis that the fees being received do not warrant the extra work. Ultimately, the quality of financial reports suffer particularly the comparability of financial information as between charities upon which funders (government grant gatekeepers or the public) may rely. There is also at times a lack of transparency with regards the charities full activities if for example, they elect not to recognise volunteer hours / labour or donated items of assets or inventory.

Overall, there is also a view that charities have received a special status in not being subject to income tax, and therefore a "government/public benefit" has been indirectly received. As such proper governance and appropriate financial reporting would still be required in a similar manner to those requirements for non-charitable entities.

To gain confidence in the charity sectors financial reports we advocate that all charities should be GAAP compliant, with regards to financial reports.

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

We agree in principle with the objective to find an appropriate balance between the benefits associated with increased quality and reliability of financial statements if they are being assured and the additional costs associated with the level of assurance provided.

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

We believe larger registered charities should be required by legislation to have an assurance engagement completed at the 'Audit' level of assurance.

It is acknowledged that other jurisdictions such as the UK allow a lower level of assurance with the use of an 'Independent examination', however there is still a lack of understanding on what this lower level of assurance actually means and the terminology used is not widely understood by the end users of the financial statements. This leads to the accounting profession having to continually educate their clients on the difference between an audit and other forms of assurance. Many users of financial reports remain unable to determine the difference between an audit and a lower level form of assurance and given the choice will opt by default toward the lower cost engagement.

From the Audit firm's perspective there is still a certain level of fixed cost involved in conducting any form of audit or assurance engagement. There are certainly significant costs incurred by audit firms training their staff to comply with all NZICA rules and regulations, including Quality Control and all International Standards on Auditing (New Zealand) (ISA (NZ)'s) when conducting an Audit of historical financial information. These standards are highly prescriptive and they ensure all audits regardless of the size of audit firm and the size of the client have a common standard for audit methodologies maintained across the whole accounting profession. The same can not be said about Review engagements, which could more likely be based on practitioner's varying levels of assessment of requirements for a review. Therefore, a Review engagement is open to variability between different audit firms and given the limit on the procedures performed it could be argued whether the charity can actually gain any reliance on Review engagement report.

However, in applying a tiered approach to assurance for charities it is clear there does need to be a feasible option for non-large charities. A Review engagement would be a sensible mechanism to at least ensure there has been an independent review of the charities' accounting policies and consideration given to GAAP compliance in the review report.

One alternative to a review engagement in the charities sector could be the use of Agreed Upon Procedures engagement. The New Zealand Institute of Chartered Accountants (NZICA) standard *APS-1: Statement of Agreed Upon Procedures Engagement Standards 1*, with the associated guidelines would govern the scope and level of reporting and all NZICA members are required to comply with APS-1 as mandatory under the Code of Ethics. APS-1 contains specific paragraphs on the engagement function in comparison to Audit and Review engagement:

*5. An agreed upon procedures engagement is a professional engagement in which a member agrees with the client to perform specific procedures with respect to financial information. In such an engagement, the member performs procedures of an audit nature to which the member and the client have agreed in order to meet the client's need for particular information.*

*6. Whereas an audit or review engagement is designed to enable the member to provide a level of assurance on the assertions contained in financial information, an agreed upon procedures engagement is not designed to provide such assurance. In an agreed upon procedures engagement, the member reports on the factual findings resulting from those procedures that have been performed.*

Whilst we acknowledge an Agreed Upon Procedures engagement does not express a positive or negative assurance, (as the provider is not expressing an opinion); it would be an acceptable form to report the results of factual findings in relation to whether government grants or other funds have been correctly spent and managed by the charities in accordance with funding conditions.

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

We would welcome the application of a legal requirement for assurance engagements to be completed on large charities. As noted in our response to Q1, the absence of this legal requirement has given rise to the large number of non-GAAP compliant financial reports.

There is we consider a real benefit for the level of assurance for large charities to be at the 'Audit' level, as follows:

- Many charities which are large in size benefit from exemption from New Zealand income tax. An Audit would ensure there is a formal check on the charities compliance with laws and regulations, including whether they have remained fully compliant with all the statutory conditions required for the tax exemptions being made available.
- The fact that charities gain from not having to pay New Zealand income tax is a significant cost saving to them, which is likely to outweigh the cost of an annual audit.
- An audit should be considered a necessary requirement in return for the tax free status charities benefit from. Particularly, where the charity becomes borderline with the statutory conditions for the tax exemption and commences entering into transactions of a business nature.
- A number of large charities are funded by government grants obtained, therefore it is in the public interest that those large charities should have their financial statements audited to determine if the conditions attached to the grant have been fulfilled and spent on the purpose for which they obtained.
- The audit is a mechanism to raise the standard of charitable organisations governance. The auditors written management reports to the charities board will raise recommendations for improvement of the charities systems and potentially reduce the risk of significant matters such as fraud.

The research in the discussion documents suggests GAAP compliance will not become mandatory unless there is a legislative requirements to do so.

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 all large registered charities should be required to have an audit to meet similar statutory obligations that are imposed on the For-profit sector and gain from the benefits of obtaining an audit; particularly in terms of promoting good governance, which is currently lacking in the charities/not-for-profit sector.

The parameters that define whether a charity is large or 'less large' need to be set at a level that will spread a wide sized net over the sector as a whole. We acknowledge there is a fine balance between costs versus benefits. However, the net needs to be far reaching enough to capture all the charities that have avoided any form of audit / assurance against the requirements of their own constitution. Registered charities need to be regulated to ensure those that do voluntarily undertake an audit are not disadvantaged when comparisons are made for grants/funding applications against other organisations who have actively lowered their assets or income to look poor.

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?

Annual revenue as a measure tends to be variable depending on the charities activities, for example there may be peaks when there has been a significant fundraising drive in one year. Hence annual revenue would not be a suitable limit in determining the level of assurance required.

We consider that operating expenditure would be considered the more reliable measure given there will be some fixed costs as well as peaks in the variable costs. However, we consider a mixture of an

operating expenditure level and total assets test is required to ensure the asset-rich charities are captured within the regime. Also, some charities may have significant capital projects or capital assets held, which would not be identified on an operating expenditure only test.

We consider that employee numbers is not a relevant test for charities that are heavily reliant on volunteer hours (which they may not be capturing) and outsourced facilities, hence the entity size is difficult to determine on this measure.

Tiers for assurance reporting appear to be the only viable option considering the costs versus benefit balance needed.

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

*49 It would be essential to take a tiered approach if, for example, assurance was to be required for registered charities with operating expenditure of \$50,000 or more because it is very unlikely that there would be enough qualified accountants to carry out the work at a price that a \$50,000 a year charity could afford to pay. However, this would not be the case if assurance were only to be required for charities with operating expenditure of, say, \$500,000 or more. Therefore we consider that a choice needs to be made between the following:*

**Option A:** A combination of (i) a higher proportion of registered charities being required to have an assurance engagement completed and (ii) certain non-accountants being permitted to carry out relatively simple engagements; or

**Option B:** A combination of (i) a lower proportion of registered charities being required to have an assurance engagement completed and (ii) requiring all of those engagements to be carried out by qualified accountants.

We agree a tier approach on who can perform the audit and assurance is a practical solution in comparison to those operating in other jurisdictions. Our preference would to see another option to those described above.

**Option C:** A combination of:

- i. A lower proportion of registered charities being required to have an audit engagement. Say, all large charities to be audited by a registered auditor. The register auditor would be the same auditors who are licensed under the Auditor Regulations Act 2011. The argument for this being Issuers can only be audited by licensed auditors due to the complexity of those entities and to protect the public interest, it would be sensible to apply this same logic to larger charities. Larger charities are more complex than other charities and there are further consequences for stakeholders in those entities, this requires a higher level of auditor skills and competence.
- ii. A higher mid-tier of registered charities being required to have an assurance engagement completed. To be performed by members of designated professional accounting bodies (qualified accountants only, based on New Zealand Companies Act 1993, section 199) who are approved auditors on the basis that this status of auditor is implemented in the future.
- iii. Third tier with a low level, exemption from any audit or assurance, such as very small local sporting clubs, or others that fit certain criteria like small religious organisations, etc.

The use of non-accountants who are not bound by the same Code of Ethics, as those set out by the New Zealand Institute of Chartered Accountants would discredit the level of assurance gained from engaging a suitably qualified accountant. The opportunity for non-accountants to fail to apply GAAP compliance would not solve the problem definition.

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?

We agree in principle with the tentative proposal, however consideration should be given to asset-rich charities as outlined in our response to Q.6.

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?

It would be sensible for legislation to allow for periodic review of the measures for audit and assurance for charities to be increased for the effects of inflation. We are in agreement in principle and would see the benefit in the review being at intervals of between every three to five years to avoid confusion in the charities sector given they will be undergoing a major compliance change from now and the year 2015 with the adoption of the new financial reporting framework as well as the audit and assurance requirements.

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

The costs of an audit or a review in terms of a dollar amount is skewed towards the lower end of what an audit / assurance provider would typically charge. The main reason for this is due to charities finding honorary auditors or having an historically low fee set that has not been revised to account for the fixed costs incurred by the auditor to maintain the high level of audit quality, professional ethics and the suite of International Standards on Auditing (New Zealand) (ISA (NZ)'s) introduced from 1 October 2009.

In summary, the charity sector has become accustomed to too many auditors performing audits on an honorary basis, which could result in a lack of quality on those audits.

Audit and assurance fees are not set purely on the size, but take into account the complexity of the entities activities, how varied the income streams are, how much reliance is being placed on outsourcing and how to assess those Service Organisations and the overall audit risks involved. These qualitative indicators rather than dollar values have to be factored into the assurance provider's fee, which are not transparent in the ratio of charity size and the cost table.

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?

In any tiered regime there would be entities moving up and down the scale of the tiers. It would be encouraged for charities currently having an audit to continue with this high level of assurance to promote confidence in the sector. In some cases the charity will still have a constitutional requirement for an audit. There are clear benefits of audit to promote transparency and accountability to potential funders, donors and to ensure funds obtained from the public are being used effectively and efficiently.

In any event there will be some charities considering their legal requirements that will opt for the least level of resistance and switch to a review, but given the current regime has been somewhat optional we would expect the current charity audits to continue.

Q12. Do you have any other comments?

The tentative proposal set out in Q.8, does not take into account related entities. This can become problematic where there is a question over whether there is control present and if consolidated financial statements are required to remain GAAP compliant. If the measures are set at the entity level only, this could result in charities seeking to lower their compliance costs by the establishment of multiple entities all operating below the audit threshold.

Should you have any queries concerning our submission please contact one of the undersigned contacts on behalf of WHK New Zealand.

Yours faithfully



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