901a Ferry Rd
PO Box 13 625
Christchurch
Ph (03) 669 0542
info@commaccounting.co.nz

Towards A Not-For-Profit Standard of Accounting and Reporting

Submission - Comments on exposure draft - Public Benefit Entity Simple Format Reporting (Accrual) for Not-For-Profit Entities (PBE SFR-A (NFP))

Summary

This submission highlights some of the fundamental problems with the current proposal for accounting standards for small and medium Public Benefit Entities/Not-For-Profits. We have chosen not to follow the format of answering the specific questions provided in the discussion document as we feel that there are flaws in the proposals that cannot be addressed by ‘tweaking’ specific aspects of them.

Our key points are:

- Accounting theory has commercial entities in mind, and the accounting standards that are derived from it cannot easily be applied to not-for-profits. Not-for-profits do not incur expenditure to generate income, for example, but this idea is the foundation of accounting theory and a basis of accounting standards. The proposed standards represent an awkward adaptation of accounting standards which are suited to a commercial entity without giving enough thought on their suitability in a not-for-profit environment.
- We do not believe that XRB is the right agency to develop a suitable format for the reporting a not-for-profits outcomes, outputs and activities. This is not their area of expertise. There are many experts in the field of service evaluation that could be utilised, but they do not generally come from the field of accounting.
- The proposed mixing of financial information and other accountability indicators poses problems for auditing that have the potential to substantially drive up audit costs. It also offers new opportunities for fraudulent reporting that will be difficult to detect.
- It is in nobody’s interest to regulate the financial reporting of micro-entities. A minimum threshold must be provided before financial reporting becomes mandatory to avoid creating an unreasonable administrative burden on groups with no or very little public accountability. We suggest this threshold to be $5,000 in operating expenditure and/or $50,000 in assets.

As a result of our concerns, we recommend that the implementation of Tier 3 and 4 PBE accounting and reporting standards is postponed until a suitable process has been followed that first captures and then addresses the accounting, accountability and reporting needs of the not-for-profit sector. This includes:

1. Setting up a steering committee that involves representatives of private and government funders, community groups (including very small entities), Inland Revenue and other relevant government departments, and members of the accounting profession with relevant experience in not-for-profit accounting and auditing.
2. A literature review about evaluation and accountability (financial and non-financial) in the not-for-profit sector as it applies to small and medium-sized entities.

3. Original research that captures the accountability and reporting needs of the sector, which should involve testing how financial information needs to be presented and organised to be readily understood by those to whom small and medium-sized not-for-profit organisations are accountable, and what the role of financial information is in decision-making.
4. Drafting suitable guidelines on the basis of the literature review and research.
5. Testing the guidelines for acceptability in the sector.
6. Drafting and implementing accounting standards for the sector.

Not-for-profit nature is not adequately captured by the proposals

The proposed accounting standards for both Tier 3 and 4 do not adequately capture the not-for-profit nature of these entities. Instead, in developing the standards XRB has made modifications to the for-profit accounting model instead of considering the accounting needs and accountability environment of not-for-profits afresh.

One of the key differences between for-profit and not-for-profit entities is the consideration of Income and Expenditure. For for-profit entities, expenditure is incurred to generate income. In not-for-profits this is reversed: income is sought so that expenditure can be applied to a purpose. This is important as the expenses-to-generate-income concept is fundamental to accounting theory and permeates all NZ International Accounting Standards as well as Auditing Standards (AIS(NZ)).

Common line items in Statements of Financial Performance and Position such as 'working capital' or 'gross profit' are usually entirely meaningless in a not-for-profit setting as a result. Accommodating the not-for-profit nature of an entity in financial reporting would mean that the layout of any such statement would need to be reversed to draw attention to expenditure and to discourage readers from making value judgment calls on an organisation on the basis of a profit model. A Statement of Financial Performance could be called 'Statement of Funding' to better capture the nature of the entity, and reverse the usual order of expenditure and funding (income).

Tier 3 entities are proposed to have to produce a Statement of Cash Flows. The nature and terminology of Cash Flow statements according to GAAP is too business-focused to have any meaning in a not-for-profit environment. To consider the purchase of a non-current asset an 'investment' to achieve future economic benefit, for example, is generally a poor representation of this type of financial transaction when it occurs in a not-for-profit. Likewise, the word 'financing' is similarly misleading.

A Statement of Cash Flows could have meaning if it would 'translate' an accrual-based Statement of Financial Performance into a cash-based schedule of income and expenditure. Items that 'distort' accrual-based statements in the eyes of non-accountants, such as the capitalisation of some expenditure and the elimination of GST, could be addressed this way. It is a common problem in our work at CCA that the readers of the financial statements of not-for-profit organisations, including decision-makers such as funders or significant donors, do not understand Statements prepared on an accrual basis. We frequently face questions such as why an organisation can show a surplus when the bank balance went down considerably. A Statement of Cash Flows according to NZIAS, or the proposed Tier 3 standard, does not aid non-accountants in the understanding of the other Financial Statements, and needs to be re-thought completely.

A further basic assumption in the drafting of Financial Statements is the Going Concern question. To determine whether or not an entity is a Going Concern an auditor uses financial models to establish the ongoing viability of operations. These models are simply not applicable to not-for-profits, for three key reasons:

- Not-for-profits can generate income without incurring a liability of any kind (donations, fundraising).
- Not-for-profits do not necessarily incur expenditure for tasks in the same way as businesses do, as they have at least potential access to free labour, material donations and other 'free' goods and services.
- The future income of not-for-profits cannot be estimated from past income with a sufficient level of certainty.

However, if the Going Concern question cannot be adequately solved from not-for-profit Financial Statements, the basis of financial reporting according to GAAP is undermined, and a key use of Financial Statements is rendered moot. This provides a further strong reason why the present business-oriented financial reporting standards cannot be used as a basis to develop financial reporting standards for not-for-profits, but the theoretical underpinnings of those standards need to be reconsidered first.

Finally, there are cultural issues to consider. Many cultures with significant minorities in New Zealand do not use financial information or written reports for accountability purposes. The more administrative effort and understanding of our 'white ways' is required for compliance the more this will have an effect on the leadership of those organisations, as it strengthens 'foreign' concepts within an organisation that may well have been set up to preserve their own. This does not mean they should be left 'off the hook', but care must be taken to not prevent the formation, or endanger the ongoing viability, of organisations with a strong cultural focus through excessive compliance requirements.

New Zealand is founded on a treaty between two cultures and legislation makes certain guarantees to consult with Maori on issues that are of importance to them. We do not see that this has been undertaken.

Financial Reporting Standards for for-profits have been developed largely in response to the requirements of the users of Financial Statements (directors, shareholders and investors) and their agents. We do not see that the proposed standards for not-for-profits have followed the same path, and we believe that merely making adjustments to a profit-focused model will not yield good results in a not-for-profit environment. There appears to be high resistance against the XRB proposals for the not-for-profit sector, which does not bode well for their ability to be implemented and be complied with. Given that the statutory committees of XRB appear to consist entirely of present or past Chartered Accountants, there is a danger that this proposal's main objective is perceived as an attempt to create a new market for accountants.

Non-financial reporting

We agree that non-financial reporting is necessary for not-for-profits, but we do not believe that the proposed standard will help.

Our key concern is that the proposed standards for non-financial reporting have been developed by people proficient in business financial reporting. How an organisation can and should report on its activities is simply not XRB's field of expertise and we strongly recommend that this part is removed from the proposals altogether, and the development given to a different government department (such as Internal Affairs or Voluntary/Community Sector), or the pathway suggested in the Summary of this submission is followed.

One of the difficulties in activity reporting is the large variety of not-for-profits. The proposals appear to have not-for-profits in mind that provide ‘services’ to the community and can be considered a fairly close equivalent to a service business. However, a very large number of not-for-profits simply exist as a means to manage membership funds. This would include almost all sports clubs, many professional associations, hobby associations, neighbourhood associations and many others. These organisations do interact almost exclusively with their own members, are self-managed by those members and usually do an excellent job of internal reporting via newsletters, because otherwise they would lose those members. Fitting these entities into the proposed Statement of Service Performance is difficult, and offers little, if any, useful information.

The term ‘service performance’ in itself is a poor fit for many organisations. A social sports club, for example, does not ‘perform’ and does not provide a ‘service’. It is an administrative vehicle for people to get together in a social setting. It is counterproductive to imply that it should deliver a ‘performance’ or provide a ‘service’.

The intention of the proposed standards is to improve, or norm, reporting. Regulating how an organisation reports can impact on how an organisation manages itself, however. A lot more research and consultation needs to be done before the non-financial reporting of not-for-profits can be regulated and such regulation to produce beneficial outcomes.

Minimum Threshold Required

A fundamental weakness of the proposed financial reporting framework for not-for-profits is the lack of a minimum threshold above which organisations need to meet standardised reporting requirements.

Some of our clients that will have to comply with the proposed standards instead of producing a simple cash in- cash out report for the members are:

- A community library with total income of $840 last year (no public funding)
- A cultural playgroup with total income of $1,500 last year (some donations for toys)
- A writers club with total income of $200 (all memberships)
- An interest group for a rare health condition with a total income of $1,200 (exclusively fundraising) and expenditure of $100 last year.

We do not believe that XRB has presented any evidence that the community at large or the stakeholders in such small organisations are in favour of regulating their financial reporting. To use a popular phrase: this is completely “over the top”. The new requirements would create such additional administrative effort that is would endanger the viability and possibly change the nature of such small groups.

We also note that while in Christchurch there is a free accounting option available for such groups, this is absent elsewhere in New Zealand.

We recommend to exempt organisations with operating expenditure of $5,000 or under, or assets valued at $50,000 or under, from reporting requirements.

Audit Implications

All of our clients have assurance of their financial information undertaken, either by us or other accountants. Independent assurance is pervasive in the not-for-profit sector even for the smallest entities, largely because many funders demand it.

Because the proposed accounting standards for Tier 3 and Tier 4 entities are different to IAS (and the format of reporting in particular is different to NZIAS 1) , auditors and accountants will need training. XRB also needs to ensure that not-for-profit accounting becomes a mandatory part of any degrees that lead to accounting qualifications by the proposed implementation date to ensure auditors can competently comply with IAS (NZ) 315 (*Understanding an Entity and its Environment*) and IAS (NZ) 250 (*Consideration of Laws and Regulations*).

As they are, the proposed standards, and especially the proposed reporting templates, pose some difficulties for auditors.

An auditor cannot simply only consider only a part of Financial Statements. If Statements contain assertions about budgets (as proposed in the XRB templates) or outcomes from services (as proposed in the Statement of Service Performance) an auditor needs to ensure that these are not misleading (ISA (NZ) 720 – *Auditor's Responsibility in Relation to Other Information*). As these are indicators that have not previously been considered in audits, auditors are not used to them and are not trained in them. It cannot simply be assumed that a professional auditor will be able to follow a suitable audit path – if that assumption was true, there would be no need for International Auditing Standards, and we once again point out that no expertise in the not-for-profit model is required in the path to any degree leading to becoming an accountant, even a Chartered Accountant.

Given the prevalence of audits in the not-for-profit sector we believe that accounting standards cannot be introduced without a corresponding set of auditing standards for small not-for-profit entities. Professional guidelines in professional bodies such as NZICA are not enough, especially as the government appears to be intent on introducing more competition on the audit market and remove the current near-monopoly of Chartered Accountants.

This would have to involve some thought on what tests an auditor could conceivably undertake to verify what is essentially non-financial information that has been made part of financial reports. This would be particularly challenging where an organisation chooses to use the XRB templates and disclose budget figures. Such figures have great potential to put an organisation in a very positive or very negative light and to change the way a reader perceives the financial information. An auditor's only pathway would be to try to verify internal controls in the budget-setting process, but given the flexible nature of budgets (they would be of little use if they could not be adjusted through the year), and the realities in small organisations when it comes to internal controls, this is rather unlikely to yield definite results.

Potential for manipulation also abounds in the Statement of Service Performance. Auditors will have to verify whether the disclosures made here are supported by the financial performance and position of the organisation.

All this has the potential to greatly increase audit costs, especially for very small organisations, or to lead to qualified audits, which may well jeopardise an organisation's ability to acquire funding. We believe that this alone is a very convincing reason to keep financial information strictly separate from non-financial information.