

WHAT DRIVES SMALL CHARITIES TO OBTAIN
ASSURANCE OVER THEIR FINANCIAL STATEMENTS?

Small charities' assurance needs

IN THIS BOOKLET



Key findings



Conclusions &
Recommendations



Charities'
perspectives



Philanthropic funders'
perspectives



Government agency
perspectives

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Introduction

We wanted to understand:

- What drives small charities¹ to obtain assurance over their financial statements? and
- Are the needs of funders, such as philanthropic funding organisations (PFOs) and government agencies) appropriately addressed by the assurance engagement?

We will use the results of our research to decide whether a new simple assurance engagement should be developed for small charities.

The External Reporting Board is the independent Crown Entity responsible for accounting and assurance standards in New Zealand. The New Zealand Auditing and Assurance Standards Board (NZAuASB) has delegated authority from the XRB Board to develop or adopt, and issue auditing and assurance standards.

All XRB standards are designed to give New Zealanders trust and confidence in the financial reporting of our organisations, across the corporate, not-for-profit and public sectors.

¹ Those charities with annual expenditure between \$125k and \$500k with no statutory requirement for an audit or a review.

Methodology



We used a combination of methods, including:

- Interviewing a sample of philanthropic funding organisations — large government funding agencies (such as the Ministry of Social Development and the Ministry of Health), both private large and small local funding organisations.
- Interviewing appropriate staff of Charities Services.
- Reviewing information available via the websites of philanthropic funding organisations and government agencies.
- Reviewing New Zealand and international research literature.
- Surveys.
- Analysing data extracted from the Charities Register.



4. Stakeholders with high information demands require information about matters such as governance and management capabilities of a small charity. Lack of generally accepted criteria or framework for preparation of such information:
 - negatively affects the charity's ability to prepare such information,
 - causes inconsistent or duplicated demands for information from different government agencies,
 - causes stakeholders to use audit and reviews of financial statements as proxies for this information (also see item 8 below).
5. Government agencies that engage small charities as service providers require them to have their financial statements audited or reviewed.
6. Philanthropic funding organisations (PFOs) are satisfied with the statutory framework for assurance engagements over charities' financial statements. They are unlikely to demand audited or reviewed financial statements from small charities.
7. Lack of an appropriate level of accounting and financial reporting knowledge amongst the users of small charities' financial statements within government agencies and philanthropic funding organisations negatively impacts the usefulness of these reports.
8. Unfamiliarity with financial reporting also causes misplaced confidence on assurance reports over these financial statements and may cause these users to less carefully analyse the small charities' financial reports for their purposes.

Assurance reports may be perceived as a certificate of a high quality financial management system (e.g. risk of fraud is well managed, resources are spent according to the funding contract, the entity is financially viable and well managed etc.)
9. Both government agencies and PFOs have significant information needs for assessing the capabilities of small charities. Most of the information they require is not included in the small charities' annual reports.



Key Findings

1. Most small charities have their financial statements audited or reviewed because their founding documents require them to do so.
2. While most small charities use a combination of income sources to fund their operations, they are different in terms of their dependency on a single source of income. Income source dependency has a significant impact on type, amount and format of information a small charity needs to provide to its stakeholders.
3. Small charities that mainly depend on small contributions from a large number of individuals (donors) tend to experience low demand for formal and structured communication of information (low demand stakeholders).

On the other hand, small charities that derive a significant portion of their income from providing services to government agencies need to provide a considerable amount of information in a structured and formal manner (high demand stakeholders).

10. Both PFOs and government agencies are very interested in knowing if a small charity properly manages its financial affairs (e.g. risk of fraud is well-managed). Financial information included in the financial statements does not provide them with all the relevant information to make this decision.
11. Many small charities consider it prudent to obtain some form of external scrutiny over their financial operations and reports. However, a perceived lack of value for money of audit and review engagements is a significant deterrent for small charities to use these assurance products.
12. Small charities are very likely to use the services of chartered accountants in preparing their year-end financial statements as they are unlikely to have inhouse resources with adequate financial reporting expertise.

Conclusions

1. The information needs of certain high-demand stakeholders are not addressed at present. Appropriate criteria need to be developed to more effectively address such information needs.
2. For example, both government agencies and PFOs would find information about whether a charity has appropriate and effective internal financial controls in place (to protect the charity's assets, deter fraud, reduce the risk of waste and loss, properly manage conflicts of interest etc.) of great interest.

However, lack of a generally-accepted framework of internal financial controls (that is suitable for small charities) could prevent a charity's ability to:

- develop and implement such capabilities and
 - communicate these capabilities to concerned stakeholders.
3. There seems to be a lack of understanding by key stakeholders of small charities about:
 - the value of audit or a review engagement and what can reasonably be expected from these engagements, and

- assurance engagements other than audit and review engagements that may better suit assurance needs of stakeholders of small charities.
- 4. Small charities are unlikely to have adequate resources for both a professional accountant preparing their financial statements and paying for an audit or a review by a qualified auditor.
- 5. More research is needed to understand if new types of professional services can be developed that will maximise the value for money for small charities.



Recommendations

- Liaising with Charities Services of the Department of Internal Affairs along with the professional accounting bodies to use the guidance we already have to raise awareness about audits/reviews and other assurance engagements amongst key stakeholders of small charities.
- Further exploring the viability of the development of a new engagement standard and/or guidance for small entities as an alternative to an audit or review. For example, such an engagement could encompass helping small charities prepare their financial statements, verify key information against appropriate records, review key internal controls and provide feedback on how these can improve.
- Sharing the findings of this research with interested parties such as Charities Services, professional accounting bodies etc.

Charities' perspectives



According to information we extracted from the Charities Register, there are 2,565 charities with a total annual expenditure between \$125K and \$500k (referred to as small charities from now on) with financial year-ends on 31 March 2016 and onwards. These charities have submitted their annual reports for their most recent financial year. There is no statutory obligation for them to have their financial statements audited or reviewed.

The following table summarises the number of small charities that had their financial statements audited or reviewed in their most recent financial year compared to those who had not:

Comparing those with audited and reviewed financial statements vs those without

Founding document requires financial statements to be audited or reviewed	Financial statements audited or reviewed	No assurance engagement required	Total
Yes	1,507	92	1,599
No	122	844	966
Total	1,629	936	2,565

Table 1 shows 1,629 out of 2,565 small charities (64%) had their financial statements audited or reviewed in their most recent financial year. This is despite the fact that there are no statutory requirements for the small charities to do so.

Less than 13% (122 out of 966) of small charities that did not have a requirement in their founding documents to have their financial statements audited or reviewed, have done so. This suggests the main reason small



charities have their financial statements audited or reviewed is that their founding documents require them to do so.

Interviews with PFOs and reviews of their guidelines for grant applications indicate that there is no pressure from them for small charities to have their financial statements audited or reviewed. However, there is pressure from government agencies with significant service contracts (with significance thresholds varying between government agencies) on small charities for audited financial statements.

An analysis of the data we extracted from the Charities Register also supports the above.

Average income by source — those with audited or reviewed financial statements vs those without

Source of income	Audited or reviewed financial statements		No assurance engagement	
	Amount	% of income	Amount	% of income
Providing goods or services	\$112,646.93	39%	\$71,121.26	27%
Donations / Koha	\$101,982.72	35%	\$107,914.08	40%
Interest and Dividends	\$22,380.27	8%	\$32,725.75	12%
Membership fees and subscriptions	\$29,730.50	10%	\$29,409.34	11%
All Other Income	\$21,215.92	9%	\$26,760.85	10%
Total	\$287,956.33		\$267,931.29	



Table 2 shows the average income of all small charities (in their most recent financial year) by source of income and compares this average between those charities that have their financial statements audited or reviewed and those that have not.

- Charities that have their financial statements audited or reviewed depend more heavily on income from providing goods and services (39% of their total income).
Small charities with no assurance engagements are not as dependent on this source of income (27% of total income their total income is from providing goods and services).
- Income from providing goods and services is the main source of income of small charities that have their financial statements audited or reviewed. It is, however, the second source of income for those charities with no assurance engagement.
- Charities that have their financial statements audited or reviewed receive an average of \$41,526 more income providing goods and services (compared to those with no assurance).

Interestingly, small charities with no compilation engagements over their financial statements receive more donations (including grants from PFOs) compared to the other group.

Another interesting finding is that 50% of small charities² that did not have their financial statements audited or reviewed in their most recent financial year, have their financial statements compiled by a chartered accountant. Lack of in-house capabilities for preparing financial statements is the main reason here.



Nevertheless, assurance engagements are seen by those charged with governance of small charities as a mechanism to provide credibility to their financial statements. Prior New Zealand and international research has shown that those charged with governance of small charities (with the exception of religious organisations) demand some form of scrutiny over the financial statements for both:

- their own peace of mind, and
- signalling proper financial conduct to those who appointed them as members of the governing body of the small charity.

² This number is based on reviewing financial statements of a randomly selected sample of 212 small charities from the data extracted from the Charities Register. It should be noted only those small charities that included a compilation report in their financial statements were counted as "used compilation services". The actual number of small charities who use services of a chartered accountant to prepare their year-end financial statements is likely to be even higher.

PFOs' perspectives



Do Philanthropic Funding Organisations (PFOs) currently require assurance over small charities' financial statements?

PFOs are unlikely to require any assurance over the financial statements of small charities unless it is required by the charity's founding documents.

It is important for PFOs that an applicant charity complies with its founding document's requirements. The assurance report is more a signal of good governance than the report being useful by itself.

It is usual that PFOs' organisational structure and administrative processes are such that the financial statements and associated assurance reports (if any) of applicants are seen only by funding officers reviewing the funding applications.

Some of these officers do not have an adequate understanding of assurance reports over charities' financial statements. For example, they may be unaware that there are differences between an audit and a review, or what is conveyed by an assurance report, etc.

What are the PFOs' potential assurance needs in for small charities that are not currently addressed?

PFOs' assurance needs are aligned with their information needs.

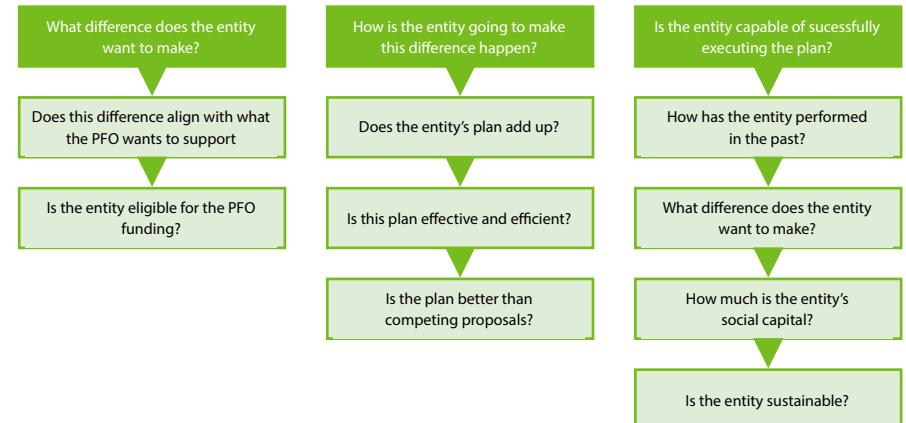
A typical PFO will require information:

- In considering a funding application or a funding candidate (pre-engagement).
- In reviewing disbursed grants (post-engagement).



Pre-engagement information needs and associated assurance needs

At the pre-engagement stage PFOs require information in relation to the following key questions.



PFOs collect their information from various sources including the funding application, the charity's annual report, Charities Register, the charity's website and social pages etc.

The extent of information a PFO accumulates at this stage is significantly affected by:

- what a PFO already knows about the charity (e.g. from prior engagements, reputation and brand of the charity in the community, etc.);
- the requested amount of funding (e.g. small vs substantial) and its intended purpose (e.g. if it is expected to be spent on something tangible and easily verifiable like buying new carpets for a kindergarten).



PFOs spend time and resources to verify certain facts about an entity. These facts can be generally categorised under “entity background information”. A significant portion of this information is readily available on the Charities Register and/or the charity’s website.

In the absence of independent assurance about the validity of this information, PFOs need to verify this information for themselves. Independent verification of such information may help. This is an area where auditors of financial statements can add value from information already collected as part of their audit or review.

The most important aspect of assessing the capabilities of a charity is its performance.

PFOs welcome the addition of a Statement of Service Performance (SSP) to charities’ annual reporting requirements. However, the information presented in the SSP of a Tier 3 charity is not always very useful.

This is because:

- Tier 3 entities are required to report only what outcomes they want to achieve (which are usually those already outlined in a variety of sources such as the entity’s founding documents, its website, its application proposal etc.).
- Usefulness of output information is determined by how closely the outputs are correlated with the overall desired outcome the charity seeks to achieve or contribute to.

For example, output information provided on a ‘children learn to swim’ programme (with the objective of reducing child drowning) is likely to be useful information.

However, output information about the number of people who completed a family budgeting course (to reduce financial distress for low income families) is unlikely to be useful without additional information about the impact of the classes.



Accordingly, PFOs do not see a need for obtaining assurance over SSP (except for when there is well-established expectation about the relationship between outputs and outcomes).

‘Social capital’ can be defined as “features of social organisations such as networks, norms and trust that facilitate co-ordination and cooperation for mutual benefit” (Putnam, 1995:35).

Some of the fundamental elements constituting a charity’s social capital are:

- the level of support a charity receives from other entities and volunteers,
- how well it is embedded in the community,
- its institutional and community knowledge,
- its networking and collaboration capabilities, and
- the level of trust of beneficiaries.

PFOs consider charities’ social capital to be very important and they would be keen to obtain information related to social capital (usually from their own officers’ knowledge of the charity, its community and environment).

This is an area where the PFO’s information needs are not very well addressed at present. PFOs welcome efforts into developing frameworks for measuring/ evaluating social capital that can be used by small charities. Given that such information is not available in a structured manner at present, there is no associated assurance demands.

Charities’ governance and management capabilities (e.g. financial management, level of compliance with laws and regulation, operational efficiency etc.) is an important consideration.

However, this is another area where the PFOs do not receive the information they require in a structured manner. For example, it is important for a PFO to know if the applicant charity has internal controls in place to:

- protect the charity’s assets.
- identify and manage the risk of conflicts of interest, loss, waste, bribery, theft or fraud.



- ensure that financial reporting is robust and of sufficient quality.
- ensure that those charged with governance of the charity comply with charities law and regulations relating to finance.

This is an area that there is a demand for assurance³. There will be value in providing assurance if a charity is following best practices in areas of governance and financial management.

However, the prerequisite of such an assurance engagement is the availability of an appropriate and generally accepted framework for such matters. For example, the Charities Commission for England and Wales has issued guidance entitled "Internal Financial Controls for Charities". Assurance practitioners can use this to evaluate a charity's internal controls against such criteria and provide assurance to external parties such as PFOs.

A charity's financial sustainability is a key consideration for the PFOs. PFOs use information included in the financial statements (e.g. diversity of and dependency on sources of income, level of reserves, going concern disclosures) and the charity's budget to establish if the charity is financially viable.

However, they would consider it helpful if such an assessment was completed by those charged with governance of the charity and shared with them. For example, the Charities Commission for England and Wales requires charities to perform an evaluation of why they will be financially viable in the near future and to report this in their annual report.

An example of how PFOs currently obtain information about a charity's capabilities is the Ministry of Social Development's risk assessment tool for its funding officers. Information provided in relation to these items is likely to be useful to other PFOs as well.

³ Some PFOs officers incorrectly perceive an audit or a review of financial statements as a stamp of approval for NFPs' financial and operational capabilities and internal controls. Accordingly, they expect an audit or a review engagement to meet their assurance needs for matters that are not in the scope of an audit or a review engagement.



Post-engagement information needs and associated assurance needs

PFOs usually request the charity to report back on any funding it has received.

- Financial Accountability: Did they spend the funds on what they said they would do, so the money was not wasted?
- Performance of the project: This is mainly how well the intended outcomes were achieved. The funders are open to failure realising that not all efforts are likely to result in success.

But it is important to ensure that valuable lessons are learned which can propel the funded organisation forward for their future endeavours.

PFOs are likely to verify how the money is spent by requiring the funded charity to provide evidence for the expenditure.

Also, they may undertake random audits to ensure that the grant funding is spent as it should have. The interviewed PFOs believed that such procedures are adequate in addressing their assurance needs, especially in relation to small charities.

PFOs are also likely to require non-financial performance information. However, there seems to be no formal verification of the non-financial performance information. This is likely because PFOs are not accountable for the charity's performance and so there is not a strong assurance need in relation to this information.



Government agencies' perspectives

Do government agencies currently require assurance over small charities' financial statements?

Different agencies have different requirements for entities that they contract as service providers (including small charities).

Some examples are as follows:

- The Ministry of Education (MoE) requires all entities whose services they fund to have their general purpose financial statements or special purpose financial report audited by a chartered accountant who is a member of the New Zealand Institute of Chartered Accountants (NZICA).
- The Ministry of Social Development (MSD) has four levels of accredited service providers. Level 1 has the highest accreditation standards and level 4 the lowest. The MSD requires service providers that need to be accredited under levels 1 to 3 and that receive \$100,000 or more per annum from the Government to provide audited financial statements.

Where the organisation receives less than \$100,000 per annum from the Government, it must provide evidence that it meets the applicable statutory requirements for audit and review. The organisation must meet the audit requirements under its constitution or contract agreements.

- The Ministry of Health (MoH) does not have a standard requirement for assurance over the financial statements of its service providers.



There is therefore pressure from some government agencies on small charities (with no statutory audit or review requirement) to have their financial statements audited or reviewed.

What are agencies' assurance needs for small charities that are not currently addressed?

Agencies engage small charities as service providers. Their assurance needs are aligned with their information needs.

They need information:

- when considering a small charity as a service provider candidate (pre-engagement);
- in monitoring and reviewing the small charity's service performance (post-engagement).

Pre-engagement information needs and associated assurance needs

At this stage, the agency's main objective is to establish the charity's service delivery capabilities. These are considered in the context of the sensitivity of the service, associated risks and the amount.

Crown agencies responsible for social sector purchasing (MSD, MoH, MoE, Ministry of Justice, the Department of Corrections and Te Puni Kōkiri) have agreed to use 10 social sector accreditation standards to assess their service providers.

This assessment process is called "accreditation", and allows a common understanding of provider capability and capacity.

One of the 10 standards is on "Financial Management and Systems". The objective of this standard is to determine if the organisation is financially viable and manages its finances competently. The standard requirements vary for different levels of accreditations required.



Table 3 demonstrates how the requirements gradually reduce from the highest level of accredited service providers to the lowest level.

Applicable Standards	Levels 1 & 2	Level 3	Level 4
The organisation is financially viable	√	√	√
The organisation has an effective financial management system appropriate to the size and complexity of the organisation	√	√	√
The organisation has adequate insurance cover for the size and complexity of the organisation	√	√	√
The organisation has arrangements for the regular independent audit, or in some cases review, of financial accounts	√	√	✗
The organisation undertakes forward financial planning to show that it will remain financially viable	√	✗	✗

✓ = is applicable; ✗ = is not applicable

The information used by government agencies in evaluating the capacity and capabilities of a small charity is closely related to information collected by PFOs. Information included in the financial statements is only part of the information collected and evaluated by these two main stakeholders of small charities.

Currently no research has been undertaken to understand if other stakeholder groups (such as members) would want to receive some of the information government agencies and funding organisations request and receive.



Like funders, the government agencies' interest in small charities' financial statements seems to be mainly driven by their need to assess the charities' financial management and reporting "capabilities" rather than the results itself. This indicates that an assurance engagement to provide assurance over financial management systems and procedures (e.g. internal controls) is likely to be more closely aligned with the government agencies' assurance needs.

Post-engagement information needs and associated assurance needs

An important feature of the relationship between the government agency and the charity is that the government agency is ultimately accountable for the charity's performance. A government agency needs to monitor the charity's performance in delivering the procured services and intervene when necessary to ensure that the quality of services and probity of expenditure are to their desired standards.

This focus on performance has resulted in government agencies requiring NGO service providers to report back against a Results-Based Accountability reporting framework (RBA), with outcomes being the main focus of the reporting.

The reporting requirements are incorporated in charities' funding contracts. The reporting templates are likely to include requirements for the charity to report on:

- Output (e.g. the number of beneficiaries, the number of service sessions and activities, Key Performance Indicators (KPIs))
- Outcomes

The required information is provided in a form of measured outputs and outcomes as well as narratives. The contracts are likely to include requirements for the charity to establish and maintain an information management system to support preparation of the information included in the contract reports. It seems to be a standard practice for government agencies to include an "audit clause" into their contract whereby the charities agree



to provide access and support for the government agency's audits of the service performance and information. The government agency determines the frequency and the extent of such audits.

For example, Central Region's Technical Advisory Services Limited (TAS) is likely to provide special purpose audits and evaluations to MoH and Regional District Health Boards.

Government agencies have adequate resources and infrastructure in place to address their assurance needs in relation to collected service performance information.

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The NZAuASB is a committee of the XRB established under Schedule 5 of the Crown Entities Act.

The NZAuASB has delegated authority from the XRB to develop, or adopt and issue auditing and assurance standards for assurance practitioners (including professional and ethical standards).

NZAuASB standards

Assurance standards issued by the NZAuASB are provided across three key categories:

1. **Professional and ethical standards** – these standards specify the ethical principles and quality control requirements that all assurance practitioners must adhere to.

Professional & Ethical Standards (PES)

2. **Standards for assurance engagements over financial statements** – these are the two most common assurance engagements – audit and review of the financial statements. These have been developed to provide greater confidence in the information included in the financial statements.

Auditing Standards (Au)

Review Standards (RE)

3. **Standards for assurance engagements other than audits and reviews** – these standards can be customised by an expert assurance practitioner to apply to a wide range of matters other than annual financial reports.

Other Assurance Standards (OA)