

Understandability and Transparency of the Financial Statements of Charities

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Abbreviations

AASB	Australian Accounting Standards Board
ACIE	Association of Charity Independent Examiners (England)
ANGOA	Association of Non-Governmental Organisations of Aotearoa (New Zealand)
ANZTSR	Australia and New Zealand Third Sector Research
ASB	Accounting Standards Board (England)
ASRB	Accounting Standards Review Board (New Zealand)
ATO	Australian Taxation Office
AUD	Australian Dollar
AUTEC	Auckland University of Technology's Ethic Committee (New Zealand)
BBB	Better Business Bureau (USA)
COGS	Community Organisation Grant Scheme (New Zealand)
CUAP	Committee on University Academic Programmes (New Zealand)
DGR	Deductable Gift Recipient (England)
DIAS	Disability Information Advisory Service (New Zealand)
ED	Exposure Draft
FRSB	Financial Reporting Standards Board (New Zealand)
GAAP	Generally Accepted Accounting Practice
GBP	Great British Pound
HMRC	Her Majesty's Revenue and Customs Agency (England)
IASB	International Accounting Standards Board
ICAA	Institute of Chartered Accountants in Australia
ICNPO	International Classification of Non-profit Organisation
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
ImpACT	Improving Accountability, Clarity and Transparency (England)
IPASB	International Public Sector Accounting Standards Board
IPSAS	International Public Sector Accounting Standard
IRS	Internal Revenue Service (USA)
JHCNSP	Johns Hopkins Comparative Nonprofit Sector Project (USA)
MED	Ministry of Economic Development (New Zealand)
NFP	Not-for-profit
NFPFRG	Not-for-profit Financial Reporting Guide (New Zealand)

NFPSAC	Not-for-profit Sector Advisory Committee (New Zealand)
NGO	No-governmental organisation
NPO	Non-profit Organisation
NZ	New Zealand
NZD	New Zealand Dollar
NZIAS	New Zealand International Accounting Standard
NZICA	New Zealand Institute of Chartered Accountants
OECD	Organisations for Economic Co-operation and Development
OSCR	Office of the Scottish Charity Regulator
PPE	Property, plant and equipment
R120	Financial Reporting by Voluntary Sector Entities (New Zealand)
SIR	Summary Information Return (England)
SME	Small-to-Medium Enterprise
SoFA	Statement of Financial Activities (England)
SORP	Statement of Recommended Practice (England)
USA	United States of America
USD	United States Dollar

Related Research Outputs

The following are research outputs relating to this study or literature review.

Publication in Journals

- Hooper, K., Sinclair, R., Hui, D., & Mataira, K. (2008) Financial Reporting by New Zealand Charities: Finding a Way Forward. *Managerial Auditing Journal*. 23(1), 68-83.
- Sinclair, R. & Cordery, C. (2009) Has sector neutrality had its day? *Chartered Accountants Journal*, 88(1), 48-49.
- Sinclair, R., Hooper, K. & Lai, YY (2009) Virtues and risks of poverty, *Chartered Accountants Journal*, 88(5), 34-35.

Papers presented at Conferences:

- Sinclair, R., & Hooper, K. (2007). *Financial reporting by New Zealand Charities: Finding a way forward*. Paper presented at the Accounting and Finance Association of Australia and New Zealand Conference, Gold Coast, Australia, 1-3 July.
- Sinclair, R., & Hooper, K. (2007). *Will raising the transparency of charities' financial reports cause problems?* Paper presented at the Asian Pacific International Accounting Conference, Kuala Lumpur, Malaysia, 11-14 November.
- Sinclair, R., & Hooper, K. (2008). *The complexity of financial reports in the voluntary sector*. Paper presented at the Auckland Regional Accounting Conference, Auckland, New Zealand, 28 November.
- Hooper, K., Ayoub, S., & Sinclair, R. (2008). *Accountability & Transparency in French Charities: Identifying the Problems*. Paper presented the Auckland Regional Accounting Conference, Auckland, New Zealand, 28 November.
- Sinclair, R., Hooper, K., & Ayoub, S. (2009) *Perceptions of governance in not-for-profit: agency, stewardship or a stakeholder management?* The 7th International Conference on Corporate Governance, Birmingham, England, 29th June.
- Hooper, K., Ayoub, S., & Sinclair, R. (2009) *Accountability & Transparency in French Charities: find the problem*. The 6th International Critical Management Studies Conference, Warwick, England, 13-14 July.
- Hooper, K., Ayoub, S. & Sinclair, R. (2009). *Accountability & Transparency in French Charities: find the problem*. The 32th congress of the European Accounting Association, Tampere, Finland, 12-15 May.
- Sinclair, R., Hooper, K., & Ayoub, S. (2009). *Perceptions of governance in not-for-profit: agency, stewardship or a stakeholder management?* Accounting and Finance Association of Australia and New Zealand Conference, Adelaide, Australia, 5-7 July.
- Sinclair, R., Hooper, K., & Ayoub, S. (2010). *Perspectives of Accountability in Charities*. Asia-Pacific Interdisciplinary Research in Accounting Conference, Sydney, Australia, 11-13 July.

Attestation of Authorship

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.

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Abstract

Access to charities' financial statements has recently become possible in New Zealand due to the development of a Charities Register. However, the ability to discharge accountability through financial statements depends on the financial statements being transparent and understandable, which is not currently the case. This research focused on four complexities that impact on the transparency and understandability of charities' financial statements: the accounting basis; valuation of property, plant and equipment; fund accounting; and how charities report to stakeholders, in particular, the expenditure overheads ratio. The focus of this study was firstly, on gaining an understanding of what accounting treatments charities have adopted to deal with each of these complexities, but more importantly why charities chose these particular accounting treatments. This was achieved by conducting seventy-five interviews with eighty-four participants in the charities' sector, in order to understand why charities act as they do.

This study determined there were three key reasons behind the choices that charities make in accounting treatment. The first relates to the poor knowledge of appropriate professional standards by accountants working in the charities sector. This lack of professionalism must be addressed by accounting professional bodies to ensure the integrity of the accounting profession is maintained. The second is the low level of financial literacy among preparers and users of charities' financial statements. There is a need for charities and their stakeholders, to understand charities' financial statements to ensure charities produce meaningful financial statements that can be utilised for decision making. Third, it is the aim of many charities to 'look poor' as they seek to gain more funding. This impacts the accounting method charities use and so goes against the requirement for neutrality and freedom from bias when preparing financial statements.

Accountability is seen as important for the charities sector in maintaining the confidence and financial support of the public by giving an account of charities' activities. For accountability to be successful it needs to be discharged. This study developed a charitable accountability model for charities to utilise in ensuring that accountability is appropriately discharged. This included the need for performance accountability where charities assess, and report on, their performance to ensure that they are making a positive difference in their beneficiaries' lives.

Charities need to be proactive in communicating the success of their outcomes and outputs to attract monies and to differentiate themselves from other charitable organisations. Donors and funders also need to ensure that they are supporting financially viable charities who are prudently managing their future and achieving great success in their activities. Above all it is important that donors and funders donate to a good charity, not just to a great cause.

CHAPTER 1: INTRODUCTION

1.1 Introduction

Globally the charities sector is becoming recognised as playing an important part in communities by furthering governments' social objectives through increasing support to disadvantaged members of society. This is also the case in New Zealand where the New Zealand government considers that the charities sector assists them in furthering their own social objectives through, for example, increasing support to disadvantaged members of our society (Cullen & Dunne, 2006; Fisher, 2006b).

There are thousands of organisations worldwide that call themselves charities and every day these organisations call on the general public with pleas for funding for their worthwhile causes. Highlighting the importance of charities was the AC Nielsen 'Good for Life survey' which found that 85% of survey participants gave to a charity (Baker, 2004). Determining which charity to support is becoming an increasingly difficult dilemma for the public, however, one way in which stakeholders can determine which charity to support is through examining charities' financial statements

The research presented in this thesis examines the complexities with transparency and understandability of charities' financial statements. Whilst there has been research done on what accounting methods charities use, there has been no research on why charities choose their particular accounting methods. Hence, this research aims to fill a substantial knowledge gap in this area. *Chapter One section 1.3* further discusses the research question, and the next section provides the background to the research.

1.2 Background to the research

In 2006 the New Zealand Minister of Finance and Minister of Revenue estimated that there are 90,000 not-for-profit (NFP) organisations within New Zealand who in 2005 received an estimated NZD356 million in donations from the public (Cullen & Dunne, 2006). The New Zealand government wants to encourage continued donations to further assist the Government's social objectives. To achieve this goal, the public needs to feel confident in donating monies to the NFP sector, in particular charitable organisations. This money comes from two key sources; individual donors and funders from philanthropic trusts.

The key issue for donors and funders is which charity to support. This choice is made harder by the charities sector attracting controversy by charitable organisations being

used to fund terrorists (Dogar & Shahzad, 2008; Hope & Gardham, 2008; Rosenberg & Simpson, 2008). As well as this threat, the continual growth in the charities sector and the resultant myriad of charitable organisations makes it increasingly difficult for funders and donors to determine which charitable organisation to support. So charities seeking funds may see further pressure exerted on them to demonstrate their accountability, as accountability is at the very basis of the development of trust (Abraham, 2007). One way in which funders and donors can determine which charities to support is through charities' financial statements. Unfortunately, a key issue that funders and donors face is that charities' financial statements are not always transparent and understandable, but can be opaque and not represent the charities' activities in any way.

In New Zealand, this task is important as registered charities' financial statements have become available through the Charities Register kept by the New Zealand Charities Commission (Charities Commission, 2006d). The Charities Commission considers that the Annual Returns, to which charities' financial statements are attached, placed on the Charities Register will help promote public confidence in charities (Charities Commission, 2008b).

As mentioned previously, these financial statements are not always transparent and understandable to stakeholders. Studies in the United Kingdom (Bird & Morgan-Jones, 1981; Connolly & Hyndman, 2000, 2001, 2004; Hines & Jones, 1992; Hyndman & Kirk, 1988; Palmer, Isaacs, & D'Silva, 2001; Williams & Palmer, 1998) and New Zealand (Hooper, Sinclair, Hui, & Mataira, 2008; Newberry, 1992, 1995b; Rees & Dixon, 1983) have revealed some complexities related to the understandability and transparency of the financial accounts of charities.

Next, the following will be highlighted: the research question and the four key complexities that impact the transparency and understandability of charities' financial statements.

1.3 *Research problem and research questions*

The aim of this study is to examine the complexities relating to transparency and understandability in the financial statements of organisations that exist to carry out charitable purposes. The focus of this study will be on gaining an understanding of what accounting treatments charities have adopted for each of the complexities mentioned.

More importantly the study will look at why charities have chosen these particular accounting treatments. Previous research has focused only on what accounting treatments charities adopt (Charity Commission, 2004; Connolly & Hyndman, 2000, 2004; Hines & Jones, 1992; Palmer et al., 2001; Williams & Palmer, 1998). Jetty and Beattie (2009) more specifically highlighted the lack of research regarding the purpose and premise of disclosure by charities. This research aims to go beyond this previous research by determining not only the particular accounting treatments used but why they are adopted. The key research question for the current study is “*What are the problems, in terms of transparency and understandability, with the financial statements of charities?*”

In considering this research question, the multiple realities revealed through the experiences of interviewees included in this study will establish a theoretical basis for analysing the research data, and guide the development of practice aimed at improving the usefulness of charities’ financial statements through ensuring they are transparent and understandable to their users.

This research will focus on four specific complexities that will be identified in the literature (*Chapter Three*) as limiting the understandability and transparency of the financial statements of charities. More specifically, the research addresses the following specific questions relating to each complexity.

ACCOUNTING BASIS

- a. Which accounting basis was used in the preparation of charities’ financial statements?
- b. Why do charities use this basis?
- c. How do charities account for donations, especially pledges?

PROPERTY, PLANT AND EQUIPMENT

- a. How do charities record PPE in their financial statements?
- b. How do charities value donated PPE?
- c. Why do charities do this?
- d. Do charities depreciate their PPE? If so how?

FUND ACCOUNTING

- a. Do charities have any funds or reserves? Yes / No
- b. If Yes: What are the funds or reserves for?

- c. Do charities distinguish between funds that are restricted, i.e. funds must be used for a specific purpose, or unrestricted? Why?
- d. Where do charities show funds and reserves on the financial statements?
- e. Why do charities show them like that?

REPORTING TO STAKEHOLDERS

- a. Do charities record the expenditure overheads ratio separately in the financial statements?
- b. If yes: Why do charities choose to separately record the ratio?
- c. If not: Do charities separately record administration and fund raising expenses so that the expenditure overheads ratio can be calculated?
- d. If yes: Why do charities separate the expenditure?
- e. If no: Why do charities not separate out the expenditure?
- f. If charities are not reporting their expenditure overheads ratio how are charities reporting to their stakeholders?

This section has outlined the research question and the questions relating to the four complexities addressed in this study. The next section focuses on the specific justification for this study.

1.4 Justification for the research

The NFP sector, of which charities are a significant part, has a large global presence. Confirmation of this is the United Nation's project being undertaken by Johns Hopkins Institute for Policy Studies (2003). This project is designed to develop a body of information about the NFP sector and as at November 2008 is taking place in forty-six countries. The United Nation considers that NFPs have a major economic presence in countries throughout the world and are increasingly becoming a focus of concern from policy makers, who have been looking for ways to improve the quality of services and reduce the size of government (Johns Hopkins Institute for Policy Studies, 2003). More specifically, the Association of Chartered Certified Accountants (2006, p. 2) highlighted charities' economic and political significance. The importance, in relation to New Zealand, is seen in the study conducted by the Office for the Community and Voluntary Sector (2008) who found that 2.7 million people out of a population of four million, donated time, money or goods to the charities sector.

Unerman and O'Dwyer (2008, p. 801) highlight that there has been very little academic research into examining issues of accountability within specific non-governmental organisations, of which charities are a subset. This was earlier noted by Flack and Ryan (2004) who considered that there had been limited research on accountability, in particular, appropriate accountability discharge mechanisms.

The importance of the sector, together with the lack of research conducted by previous researchers on the research question (*section 3.2*), justify the importance of conducting this research. As well, the recent proposals by the New Zealand Ministry of Economic Development (MED) and the New Zealand Accounting Standards Review Board (ASRB) to amend the Financial Reporting Act 1993 highlights the importance of gaining an understanding of why private NFP organisations, in particular charities, act as they do in relation to accounting treatments.

The intended contribution of this study is to promote the development of charities' financial and non-financial reporting standards, either through the New Zealand Institute of Chartered Accountants or the Accounting Standards Review Board, and to specifically address some of the complexities in the financial statements of charities. Such development will go a long way to meeting the New Zealand government's goal of funders and donors using the financial statements of charities in their decision making as to where to contribute. The importance of quality standards was highlighted by Connolly, Hyndman and McMahon (2009, p. 37) who considered that:

The widespread adoption of appropriate accounting and reporting practices has the potential to provide a basis for greater confidence in the control processes within charities and result in a more accountable and more legitimate [charities] sector.

The next section presents an overview of the research methodology and methods used for this study.

1.5 Methodology

This study is a qualitative inquiry into the accounting methods charities in New Zealand use. It seeks to gain a deeper understanding of the research, beyond what accounting methods charities use to examine why charities use those methods (Hill & McGowan, 1999). Of particular relevance to this study is the naturalistic paradigm, which is in line with the aim of this study: to understand the reasons charities act as they do in their natural setting in order to present reality as it is (Grimwood & Tomkins, 1986).

Previous research has focused on what accounting treatments charities have by analysing charities' financial reports (Charity Commission, 2004; Connolly & Hyndman, 2000, 2004; Hines & Jones, 1992; Palmer et al., 2001; Williams & Palmer, 1998) or by having charities complete questionnaires (Bird, 1985; Bird & Morgan-Jones, 1981; Blasch, Folpe, & Weiss, 1994; Connolly & Hyndman, 2001; Hyndman, 1990, 1991; Newberry, 1992; Palmer, 1997; Rees & Dixon, 1983).

This research aims to go beyond this previous research by gaining an understanding of why charities chose that particular accounting treatment. This was achieved by conducting in-depth interviews on the particular accounting treatment used, as interviews could provide insights in to the decisions made by charities in determining their accounting policies (Connolly & Dhanani, 2009; Messner, 2009).

For this research participants were: (1) people involved in the preparation or auditing of the financial statements of charities; (2) managers of charities; (3) board members of charities; and (4) experts in charities. Some interviewees were in groups which led to a total of eighty-four participants involved in seventy-five interviews that sought to determine the complexities with transparency and understandability in charities' financial statements. This data was analysed using NVivo 8, a computerised qualitative data-analysis software package (*section 4.6*) utilising accountability theory (*Chapter Five*) as the framework against which the data was collated, analysed and reported.

The analysed interview data was used to gain insights into why charities choose their accounting methods, and to determine the barriers to improving the transparency and understandability of charities' financial statements, thus supporting evidence-based policy making (Buijink, 2006; Jetty & Beattie, 2009) which is discussed in *Chapter Nine, section 9.4*. The methodology and methods for this study are discussed further in *Chapter Four*. The next section provides an overview of the different charity nomenclature.

1.6 Charity Nomenclature

One feature of the charity sector is the profusion of nomenclature used to describe organisations that exist for reasons other than making a profit. These include: NFP, public benefit entities, donee organisations, voluntary organisations and non-governmental organisations. It is therefore important that the meaning of 'charities'

adopted here is clarified, as the literature incorporates studies using this range of nomenclature.

1.6.1 Not for Profit

There are numerous definitions for NFP, including Dunn and Riley's (2004, p. 646) very simple definition: "*organisations that commit themselves to applying their assets only to their chosen purposes, and not to distribute their assets to their owners*".

CPA Australia (2007) undertook extensive research on defining a NFP entity and identified nine criteria that participants in the research considered met the definition (Kilcullen, Hancock, & Izan, 2006, 2007a, 2007b). Meanwhile, the United Nations commissioned the Johns Hopkins Comparative Nonprofit Sector Project (JHCNSP) to define and measure the size of NFP organisations. The JHCNSP proposed a definition with only five, rather than nine, criteria (2003), namely the entity: (1) has an organisational structure; (2) is NFP; (3) is institutionally separate from government; (4) is self-governing; and (5) is non-compulsory.

The New Zealand working party for the JHCNSP, have utilised this definition (Tennant, Sanders, O'Brien, & Castle, 2006). However, Morris (2000) does highlight some deficiencies in the JHCNSP definition, such as the exclusion of mutual aid organisations, but she notes it is still the most widely recognised definition for NFP and the one predominantly used in New Zealand. It is also utilised by the New Zealand Ministry of Economic Development in their recent discussion document on the 'Statutory Framework for Financial Reporting' (2009d).

To consider the position of charities within the NFP sector it is useful to look at the JHCNSP's split of the NFP sector into the International Classification of Non-profit Organisation (ICNPO) groups (Johns Hopkins Institute for Policy Studies, 2003). The New Zealand working party (Tennant et al., 2006) applied these splits to New Zealand (*Table 1.1*). Tennant et al's groups have been utilised to provide examples of registered charities. If applicable, the Charities Register's registration number (CC) is incorporated into *Table 1.1*.

<i>ICNPO Groups</i>	<i>New Zealand example</i>
Sport, Recreational and Cultural	Gymsport Assist Trust (CC11015)
Education and research	Action Education Incorporated (CC24073)
Health	Plunket Society (registered by Region) Auckland Central Branch (CC26468)
Social services, and emergency/relief	Barnardos New Zealand (CC2184)
Environmental, animal protection	Royal New Zealand Society for the Prevention of Cruelty to Animals (registered by Region) Auckland (CC36223)
Development and housing	Compassion Housing Limited (CC10104)
Civic and advocacy groups	Consumers Institute – <i>Not a charity as advocacy is not a charitable purpose.</i>
Philanthropic and other intermediaries	Lion Foundation (CC37988)
International organisations, aid and relief	World Vision New Zealand (CC25984)
Religious congregations and associations	Anglican Church (registered by Diocese) the Diocese of Auckland (CC31449)
Unions, business and professional associations	Otago Federated Farmers Charitable Trust (CC42224)
Not elsewhere classified	Arowhenua Whanau Services (CC34799)

Table 1.1 Categories of NFP institutions

The NFP sector can also be split into other components which do not clearly delineate charities, such as public benefit which is discussed next.

1.6.2 Public benefit

Accounting standards in New Zealand do not refer to either charities or NFP but use the term ‘Public benefit entities’. Public benefit entities are defined in the New Zealand International Accounting Standard (IAS) 1 paragraph 11.2 as:

Reporting entities whose primary objective is to provide goods or services for community or social benefit and where any equity has been provided with a view to supporting that primary objective rather than for a financial return to equity holders (New Zealand Institute of Chartered Accountants, 2004a).

In New Zealand, the link between public benefit entities and charities is seen, in the third component of what constitutes a charitable organisation links to public benefit i.e.

1. It falls within one of the four charitable purposes set out in section 5(1) of the Charities Act; and
2. It should not be aimed at creating private financial profit; and
3. It provides a public benefit (Charities Commission, 2006d).

1.6.3 Donee organisations

A New Zealand study by Robinson and Hanley (2002) determined that NFP organisations received NZD282 million in personal donations from 1 April 1998 to 31

March 1999. Further, a study by the Office for the Community and Voluntary Sector estimated that 2.7 million people, i.e. 75% of the New Zealand population aged 10 years old or over, personally supported charities from 1 January to 31 December 2008 (Office for the Community & Voluntary Sector, 2008, 2009).

An important aspect of promoting giving is for the organisation that is receiving funds to have 'donee status'. Donee status can be conferred under sections DB41, DV12 and LD1 of the Income Tax Act 2007.

Those who make donations to an organisation with donee status may claim rebates or tax deductions for themselves (Cullen, Swain, & Wright, 2001). Previously there were caps on the dollar amount of charitable donations eligible for tax relief, but these caps have been removed (Dunne, 2007, 2008). For some funders this has enabled them to increase their donations. For example, the Todd family, a philanthropic family on the rich list that supports numerous charitable causes, are boosting their donations to their charitable Todd Foundation by almost 50%, knowing that for every NZD150 they give they can now claim back NZD50 (Collins, 2009).

There is a frequent assumption by donors that all donee organisations are charities when this is not necessarily the case. The act of registering as a charity results in an organisation being awarded donee status. However, the Inland Revenue Department also confers donee status to any NFP organisation that states it will use donations for philanthropic purposes within New Zealand (Davis, 2008). Thus NFPs who are not charities can have donee status.

1.6.4 Voluntary organisation

The voluntary sector is a term that is gaining in use. It implies that a substantial part of an organisation's workforce is voluntary i.e. non-paid. This is also reflected in the New Zealand study conducted by Sanders, O'Brien, Tennant, Sokolowski & Salamon (2008) who determined that there were 200,605 full-time equivalent employees within the NFP sector with 133,799 (i.e. 67%) of those being volunteers. Of those organisations, some but not all will be charities as some charities are staffed by paid workers. This is also reflected in a summary published by the Charities Commission, based on Annual Returns received as at October 2009. This shows that of the 2,217,274 hours worked per week in New Zealand charities, 70% of them (1,562,963 hours) were paid hours and 30% were volunteer hours (Charities Commission, 2009f).

1.6.5 Non-Governmental Organisation

The term non-governmental organisation (NGO) is a term more commonly used with reference to international aid organisations and the United Nations. Also used in academic literature (Agyemang, Awumbila, Unerman, & O'Dwyer, 2009; Gray, Bebbington, & Collison, 2006; Mueller, Williams, Higgins, & Tou, 2005; O'Dwyer & Unerman, 2008; Unerman & O'Dwyer, 2006b). Unerman and O'Dwyer (2006a) define NGOs as organisations which are neither public sector organisations nor private for-profit commercial organisations - quite a poorly defined term. Unerman & O'Dwyer (2006a) specifically mention that not all charities will be NGOs and give the example of private schools that are registered as charities “ *we would not regard most of the activities of an expensive private school as falling within any reasonable conception of the activities of an NGO*” (Unerman & O'Dwyer, 2006a, p. 309). An example of this can be seen in New Zealand with Diocesan School for Girls that is registered as a charity but would not be considered an NGO as whilst it is non-governmental it is private and thus does not meet the definition of NGOs.

1.7 Delimitations of scope

This section considers delimitations of scope which are within the researcher's control.

1.7.1 Countries included

The decision, in *Chapter Three*, was made to compare New Zealand's generally accepted accounting practice with that found in English and Welsh registered charities. England and Wales are treated as one jurisdiction and have a well established Charity Commission and Charities Register whereas New Zealand's Charities Commission and Charities Register are in their infancy. It was hoped that by focusing on what has happened in England and Wales an indication of possible impacts could be found for the New Zealand charities sector.

The decision was made to exclude from this study the Generally Accepted Accounting Practice (GAAP) of Australia who does not have specific GAAP relating to charities. Whilst the United States (US) has GAAP relating to NFP it does not have charities' specific GAAP as England and Wales does so the decision was made to also exclude US GAAP (Charity Commission, 2005; Financial Accounting Standards Board, 1980, 2008a, 2008b).

While GAAP was not included studies from these two countries were incorporated where relevant including United States studies impacting the charities sector such as

those by: Vatter (1947); Anthony (1978, 1989, 1993, 1995) ; Herzlinger & Sherman (1980) and Blasch, Folpe & Weiss (1994). Also included was the more recent research in Australia including work done by the Australian Government (Productivity Commission, 2009; Senate Standing Committee on Economics, 2008); the Institute of Chartered Accountants in Australia (2006, 2007, 2009a) and Kilcullen, Hancock & Izan (2006, 2007a, 2007b). However, Australia was included, in *Chapter Two*, when comparing regulatory frameworks as there is a move towards closer ties between New Zealand and Australia's charities' regulatory framework (Ministry of Economic Development, 2009b, 2009c).

1.7.2 Beneficiaries

The focus of this research is on investigating why charities act as they do in terms of their accounting practices. Thus, the research questions are not directly aimed at charities' beneficiaries. Rather this study examines the extent to which charities discharge accountability by communicating the success of their outcomes and outputs to donors.

While beneficiaries were not directly investigated in this research Connolly & Dhanani (2009) consider that discharging accountability enables charities to achieve legitimacy with their beneficiaries which goes some way towards implicitly ensuring accountability is discharged to charities' beneficiaries.

1.8 Outline of thesis

The remainder of this thesis is organised into eight chapters. The next two chapters review the literature. *Chapter Two* considers the regulatory frameworks within New Zealand and two other jurisdictions; Australia and England and Wales, and any problems within these frameworks. *Chapter Three* focuses on the research question and identifies the gaps in knowledge that established the research questions under investigation in this thesis.

Chapter Four explains the methodological approach and the methods used in collecting and analysing the research evidence before *Chapter Five* discusses accountability theory and considers the rationale for its appropriateness for this study.

The three findings chapters are framed around the accountability theoretical framework. Professional accountability is considered in *Chapter Six* by focusing on three of the

complexities affecting the transparency and understandability of charities' financial statements. *Chapter Seven* examines fiduciary accountability by focusing on the problems relating to the regulatory and conceptual frameworks identified in *Chapter Two*. The last findings chapter, *Chapter Eight*, focuses on how charities report to stakeholders, i.e. performance accountability, in relation to the fourth complexity investigated in this study.

Finally, the thesis concludes with *Chapter Nine*, which summarises the findings of the research questions and the research question. It then highlights the implications for practice and policy, before identifying further research opportunities.

1.9 Summary

This chapter laid the foundation for this thesis. It introduced the research question and research questions. Then the research was justified, different nomenclatures of charities were presented, the methodology was briefly described and justified, the delimitations were given, and finally the thesis was outlined. On these foundations, the thesis can proceed with a detailed description of the literature.

CHAPTER 2: REGULATORY & CONCEPTUAL FRAMEWORKS

2.1 Introduction

Before investigating some specific complexities with transparency and understandability it is important to contextualise the problems within the regulatory and conceptual frameworks in which New Zealand charities operate.

As well as New Zealand the regulatory and conceptual frameworks of Australia, England and Wales will be covered. John Key's joint announcement with Kevin Rudd on closer ties to Australia (Ministry of Economic Development, 2009b) has direct relevance for the New Zealand charities' conceptual framework, as the intention is for charities to utilise a single set of accounting standards and prepare only one set of financial statements (Ministry of Economic Development, 2009c). However, Australia does not have a similar regulatory framework to New Zealand. Hence England and Wales will be included for comparison as they have a similar structure to New Zealand's Charities Commission with a Charity Commission that considers both English and Welsh charities (Charity Commission, 2008d).

This chapter initially looks at what constitutes a charity and the myriad of legal structures charitable organisations utilise. The chapter will then investigate the regulatory framework, including the conceptual framework, for charities within Australia, England and Wales, New Zealand and internationally, identifying some of the problems. Next the chapter will examine the agencies that monitor compliance with this regulation.

2.2 Charitable purpose

The key element in determining what constitutes a charitable organisation is whether the reason for the organisation's existence relates to a 'charitable purpose'. The discussion relating to charitable purpose can be traced back over four hundred years initially to the Elizabethan Statute of Charitable Uses 1597 (39 Eliz., c.6) closely followed by the 1601 Statute of Charitable Uses (43 Eliz., c. 4). The Preamble to this 1601 Statute provides the first legal definition of charitable purpose. At that time all organisations must be deemed to be of public benefit to meet the definition, with the relief of poverty being the prime reason for charity in the 1600s (Fishman, 2007).

2.2.1 Pemsel case

The 1601 statute was enacted during the English Reformation and consequently religious uses were absent from the developed charitable purpose (Fishman, 2007). The 1601 statute remained 'prima facie' until the emergence of the 1891 common law test for charitable purpose which was contained in the judgement by Lord Macnaghten in *Income Tax Special Purposes Commissioners v Pemsel* (AC 531, 1891) commonly referred to as the Pemsel case.

Lord Macnaghten classified charitable purpose into four 'heads' i.e. categories (Charities Commission, 2006d; Dunn & Riley, 2004):

1. Advances education;
2. Advances religion;
3. Relieves poverty; or
4. Is otherwise beneficial to the community

These came to be known as the 'four heads of charity' and were incorporated into the United Kingdom's previous Charities Act 1960 and New Zealand's Charities Act 2005.

2.2.2 New Zealand's Charities Act 2005

Utilising the Pemsel case four heads, section 5(1) of the New Zealand Charities Act 2005 states that:

Charitable purpose includes every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community.

Charitable purpose is also defined in two other New Zealand Acts: section 38 of the Charitable Trusts Act 1957 and part YA1 of the Income Tax Act 2007. Of the two acts the Charitable Trusts Act 1957 is more specific as its definition of 'charitable purpose' in section 38 specifies eleven categories by elaborating some of the education activities and also includes sports in the definition:

- (a) The supply of the physical wants of sick, aged, destitute, poor, or helpless persons, or of the expenses of funerals of poor persons;
- (b) The education (physical, mental, technical, or social) of the poor or indigent or their children;
- (c) The reformation of offenders, prostitutes, drunkards, or drug addicts;
- (d) The employment and care of discharged offenders;
- (e) The provision of religious instruction, either general or denominational;
- (f) The support of libraries, reading rooms, lectures, and classes for instruction;
- (g) The promotion of athletic sports and wholesome recreations and amusements;
- (h) Contributions towards losses by fire and other inevitable accidents;
- (i) Encouragement of skill, industry, and thrift;
- (j) Rewards for acts of courage and self sacrifice; and

- (k) The erection, laying out, maintenance, or repair of buildings and places for the furtherance of any of the purposes mentioned in this section.

Next, the problems associated with the charitable purpose definition are determined.

2.2.3 Problems

Several countries have grappled with the charitable purpose definition. The Arthur Cox Centre for Voluntary Action Studies (2002) consider that before a concise definition can be determined there needs to be a focus on what exactly falls within the current broad heading of ‘charity’. As part of their study they conducted a review of eleven countries including Australia, England and Wales, and New Zealand.

To gain an understanding of the meaning of charitable purpose, Australia conducted a ‘Charities Definition Inquiry’ (2001). This inquiry highlights the issues and then recommends that a definition must enhance clarity whilst remaining flexible, but offers no definitive definition. This lack of decision making was further illustrated seven years later when the Senate Committee recommended that all Australian Governments should agree on a common terminology for referring to organisations such as charities, but failed to propose such a common terminology (Senate Standing Committee on Economics, 2008). This was also agreed in principle by the Australian Commonwealth Government in their response to the 2008 Senate Committee (Commonwealth Government of Australia, 2009). But Australia still has no statutory definition of charity (Senate Standing Committee on Economics, 2008) and still relies on the common law doctrine of precedent shown by the Pemsel case (The Commissioners for Special Purposes of the Income Tax Appellants; v. John Frederick Pemsel Respondent, AC531, 1891).

England and Wales based their definition on the Preamble to the Charitable Uses Act 1601 through their Charities Act 1960 (Arthur Cox & Centre for Voluntary Action Studies, 2002). However, this has been superseded by section 2 of the Charities Act 2006 which introduces a new definition of ‘charity’ (Breen, Ford, & Morgan, 2008).

The previous four heads of charity have been broadened to a list of twelve heads:

- (a) The prevention or relief of poverty;
- (b) The advancement of education;
- (c) The advancement of religion;
- (d) The advancement of health or the saving of lives;
- (e) The advancement of citizenship or community development;
- (f) The advancement of the arts, culture, heritage or science;
- (g) The advancement of amateur sport;

- (h) The advancement of human rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity;
- (i) The advancement of environmental protection or improvement;
- (j) The relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage;
- (k) The advancement of animal welfare; and
- (l) The promotion of the efficiency of the armed forces of the Crown, or of the efficiency of the police, fire and rescue services or ambulance services.

As well as meeting one of these heads an organisation's purpose or mission must also meet the general head of '*for the public benefit*' (Charity Commission, 2008a). The issue of 'public benefit' means that for an organisation to be charitable its aims must also be for a public benefit (Charities Commission, 2006h, 2006i). Of particular interest is the decision to explicitly include sporting and advocacy organisations, a decision New Zealand did not follow, as seen next.

In New Zealand a 1989 working party (Working Party on Charities and Sporting Bodies, 1989) deliberated on what constitutes a charity whilst considering an appropriate taxation regime to apply to charitable organisations. This was followed up in a 2001 report (Cullen et al., 2001) which considered the relevance of the Pemsel four heads definition of charitable purpose and proposed two options:

- (1) Maintain the current definition but have the tax exemption available only to registered charities; or
- (2) Replace the existing definition with a generic definition accompanied by detailed guidelines.

At this time no decision was made until the issue was again investigated further by the 2002 working party (Working Party on Registration Reporting and Monitoring of Charities, 2002b) who recommended that the definition be extended to include, amongst other things, advocacy and advancement of culture. However, only the four head approach was incorporated into the Charities Act 2005.

2.3 Legal structures of Charities

As this study is based solely in New Zealand, this section will focus on the structures that charities use in New Zealand rather than considering structures available to charities in other countries such as Australia and England. Currently, New Zealand has no prescribed structure for charities, which are able to utilise legal structures appropriate to the particular charity's circumstances.

Before looking at the legal structures that New Zealand charities can utilise, the two key requirements of a registered charity needs to be considered as these requirements must be met regardless of the type of legal structure that the charity has. The two key criteria are: (1) It is established and maintained for charitable purposes; and (2) It is not for the private profit of any individual or group (Charities Commission, 2006k). Any entity can become a registered charity as long as it complies with the above criteria (Charities Commission, 2009a). As at 31 December 2009 there were 24,319 registered charities in New Zealand (Charities Commission, 2009d).

The first question asked on the application form for registering as a charity is “*What is the full legal name of your entity?*” (Charities Commission, 2008d, p. 1). Thus charities with no separate legal status, such as unincorporated societies, are not considered in this study as they have no separate legal structure.

2.3.1 Limited liability Company

To gain an understanding of how many companies are on the Charities Register a search of the words ‘Limited’ and ‘Tapui’ was undertaken of the register on 23rd February 2010. These words were used as section 21 of the Companies Act 1993 states that the registered name of a company must end with either the word Limited or Tapui. This results in 849 charities being identified equalling only 3.49% of the 24,319 charities (Charities Commission, 2009d). However, this only shows companies that are registered charities; some charities may be companies that choose not to register with the New Zealand Charities Commission.

The main shortcoming of the company form as a legal structure for a charity is that there is no ‘lock’ on the assets of the company which prevents assets from being distributed to shareholders. Dunn and Riley (2004, p. 648) consider it important for organisations to signal clearly to the public that their assets are unable to be transferred out, as this will “*engender greater trust from those whose support they hope to win*”. Also, unlike a charity, companies do not focus on the pursuit of a ‘public benefit’ as a precondition for company registration (Dunn & Riley, 2004). However, this shortcoming is removed if the company is a registered charity, as then it needs to meet the public benefit criterion.

2.3.2 Incorporated Society

Another type of structure is that of an incorporated society. Societies can be either unincorporated or incorporated. Incorporated societies must meet the definition of section 4 of the Incorporated Societies Act 1908, which states that incorporated societies must consist of more than fifteen persons and not be for pecuniary gain. The act of incorporation creates a separate legal entity. Tennant et al. (2006) consider this structure more suitable for member-run charities.

A search for the term 'incorporated' in the Charities Register on 25 February 2010 found 6,454 results of charities that identified themselves through their title as an incorporated society (27%). This is a small portion (30%) of the 21,500 which were registered on the incorporated societies register in October 2005 (Tennant et al., 2006).

It is unclear why so many incorporated societies have chosen not to register but, this could be for a variety of reasons including the lack of incentive to register, with its extra reporting requirements given that they will still maintain their tax exemption through the Inland Revenue Department. However, for those incorporated societies that have registered, section 23(4)(b) of the Incorporated Societies Act 1908 says that they do not have to file an annual financial statement with the Registrar of Incorporated Societies. As their financial statements attached to the Charities Register are sufficient.

2.3.3 Charitable Trust

Registering under the Charitable Trusts Act 1957 ensures that the charitable trust is a separate legal entity (Charities Commission, 2006g; Ministry of Economic Development, 2005). The Income Tax Act 2007 section HC13 defines charitable trust as a trust in which all income is held for charitable purposes. Therefore, charitable trusts are a subset of charities.

Fishman (2007) considers charitable trusts to be the primary mechanism for the transfer and holding of charitable assets. This was reflected in a search of the term 'trust' in the Charities Register, which identified 10,872 registered charities (45%) with 'trust' in their name. As at October 2005 there were 15,000 charitable trusts on the Charitable Trust Register and of those 73% have registered as charities (Tennant et al., 2006). This means that not all charitable trusts have registered as charities, perhaps for similar reasons as incorporated societies discussed in the previous section. Next the problems related to these legal structures will be considered.

2.3.4 Problems

As with charity nomenclature the problem with so many different structures can be one of confusion for prospective benefactors and beneficiaries of charities. Dunn and Riley (2004) consider that there is a need for an appropriate structure tailored to the distinctive needs of the sector.

Australia takes this on board in two recent reports which both recommend a single, mandatory, specialist legal structure for NFPs (Productivity Commission, 2009; Senate Standing Committee on Economics, 2008). The Australian Government is still considering this (Commonwealth Government of Australia, 2009). However, this matter was not raised in the discussion documents released on the proposed statutory framework in New Zealand (Accounting Standards Review Board, 2009; Ministry of Economic Development, 2009d). Having a single incorporated form is likely to result in increased costs, e.g. changing constitutions and trust deeds, with no resulting benefit to organisations and the users of their financial reports (Cordery & Sinclair, 2010b). Next the regulatory and conceptual frameworks available to charities in Australia, England and Wales, Internationally and in New Zealand are determined.

2.4 Regulatory and Conceptual frameworks

A sound regulatory system for Charities is important to maintain trust in the charities sector. Additionally, in relation to financial statements, appropriate conceptual frameworks are also needed as part of the regulatory framework. Conceptual frameworks establish the concepts, i.e. Generally Accepted Accounting Practice (GAAP) that underpin general purpose financial reporting for a particular sector or country (International Public Sector Accounting Standards Board, 2008a).

A variety of approaches exist in charities' regulatory and conceptual frameworks and those of Australia, England and Wales, and New Zealand will be considered next as well as looking at the international conceptual framework. However, this chapter will cover only an overview of the conceptual frameworks. Specific aspects of the frameworks that relate to the issues of transparency and understandability considered in this research will be reviewed in *Chapter Three*.

2.4.1 Australia

Australia has had numerous investigations relating both implicitly and explicitly to the charities sector including:

- Report of the Inquiry into the Definition of Charities and Related Organisations (Charities Definition Inquiry, 2001) which recommended the establishment of an independent administrative body for the charitable and related sector;
- Disclosure regimes for charities and not-for-profit organisation (Senate Standing Committee on Economics, 2008) which also recommended a single independent regulator for NFPs; and
- Contribution of the Not-for-Profit Sector: Draft Research Report: (Productivity Commission, 2009) which again recommended that a national body for the NFP sector be established.

To date, the Australian government has responded only by saying that they will consider this recommendation (Commonwealth Government of Australia, 2009). Pro Bono Australia (2009) expressed the frustration of many in the sector by lambasting the Government for their inaction, which leaves the Australian Taxation Office to monitor the sector through the income tax exemption (Arthur Cox & Centre for Voluntary Action Studies, 2002; Ferguson, 2006).

This lack of government action is of concern considering that the NFP sector in Australia contributes AUD43 billion to Australia's GDP with over 600,000 NFPs (Productivity Commission, 2009). Given John Key's joint announcement with Kevin Rudd on closer ties to Australia (Ministry of Economic Development, 2009b) New Zealand will need to pay close attention to progress in this area to consider the impact for the New Zealand Charities Commission.

2.4.1.1 Regulatory framework

Australia is a federation of states and territories with a resultant division of constitutional powers between the states and the federal government. Thus the regulatory environment for charities needs to be considered at both state and federal level (Arthur Cox & Centre for Voluntary Action Studies, 2002). Whilst at federal level there is a focus on sector neutrality, at state level New South Wales has introduced legislation that goes against the nature of sector neutrality. The Associations Incorporate Act 2009 establishes a scheme for the registration of associations engaged in small-scale, not-for-profit activities. This Act addresses the issue of small non-profits being overburdened by introducing a two-tiered financial reporting system that will distinguish small and large associations on the basis of a financial threshold, which has

yet to be determined. This ensures that small NFPs, including charities, have fewer requirements on financial reporting than the large associations.

2.4.1.2 Conceptual framework

Recent studies and reports in Australia have focused on the NFP sector as a whole rather than specifically looking at the charities sector (Productivity Commission, 2009; Senate Standing Committee on Economics, 2008). With regards to the NFP sector, the Australian Accounting Standards Board (AASB) considers there is a need to review financial reporting guidelines in the NFP sector (Australian Accounting Standards Board, 2008). It considers that “*there is a high risk that other information specific to private sector NFP entities and needed by users is not being disclosed, or is not being disclosed in a consistent manner*” (Australian Accounting Standards Board, 2009, p. 1). Ferguson (2005) also highlights that even though some charities have available good financial statements, other charities do not release any financial statements as there is no legal requirement to do so.

Australia also appears to still be in the ‘committee stage’ with regards to a NFP conceptual framework. The publication of the report on ‘*Disclosure regimes for charities and not-for-profit organisations*’, recognises that accounting standards are providing inadequate guidance on issues relating to charities, such as bequests (Senate Standing Committee on Economics, 2008). However, the AASB has followed England and Wales’s (Accounting Standards Board, 2007a) stance by stating they would “*not be inclined to look at standards specific to NFP organisations without first having an international precedent*” (Senate Standing Committee on Economics, 2008, p. 107). This is contrary to CPA Australia (2006a, p. 1) which considers that “*where the needs of NFP entities are not addressed by international bodies suitable domestic guidance should be developed*”.

A second report published in 2009 on the ‘*Contribution of the Not-for-Profit Sector*’ (Productivity Commission, 2009) again acknowledges that reporting needs improvement. However, this report, as well as endorsing a ‘one-size fits all’ standard chart of accounts for NFPs receiving government grants or service contracts, promotes a national register for Australia NFPs (Productivity Commission, 2009). The Commission considers that this would allow for ‘robust comparison’ amongst NFPs but appears to ignore the mammoth task of registering the 600,000 NFP organisations in Australia.

Currently, there is no specific conceptual framework that applies to charities in Australia (Arthur Cox & Centre for Voluntary Action Studies, 2002) as Australia operates under sector neutrality i.e. a single conceptual framework using International Financial Reporting Standards (IFRSs) for all sectors. The Institute of Chartered Accountants in Australia (ICAA) has tried to aid NFPs in their preparation of financial statements by producing a report of best practice for NFPs entitled '*Enhancing not-for-profit annual and financial reporting – Best practice reporting*' (Institute of Chartered Accountants in Australia, 2009a). CPA Australia had earlier also tried to assist NFPs with their report '*Financial Reporting by Not-for-Profit Entities*' (CPA Australia, 2000).

The AASB and New Zealand's Financial Reporting Standards Board (FRSB) have developed a process for modifying, or introducing additional requirements to IFRSs for NFPs (Australian Accounting Standards Board & Financial Reporting Standards Board, 2009). Neither this process nor the above reports address the core issue, which is their basis in IFRSs that are prepared for 'for-profit' organisations rather than NFP organisations (Dellaportas, Langton, & West, 2008; Ellwood & Newbury, 2006; Gurd, Palmer, & Wilson, 2008). In fact, CPA Australia considers that Australia's move to IFRS fails to take into account "*how radically NFPs differ from commercial entities*" (CPA Australia, 2006b, p. 1). One country that has developed a conceptual framework for its charity sector is England and Wales which will be considered next.

2.4.2 England and Wales

New Zealand has a similar regulatory environment for charities as England and Wales. However, whilst New Zealand's Charities Commission has operated only since the 21st century, in England and Wales there has been some form of Charity Commission, covering both England and Wales, since the mid 19th Century (Tomlinson & McGlenn, 2004).

2.4.2.1 Regulatory framework

The duties of the Charity Commission were last reviewed in 2002 by the Cabinet Office Strategy Unit (Charity Commission, 2003) which led to the enactment of the Charities Act 2006 that replaced the Charities Act 1960. As well as this primary legislation there is some secondary legislation, including The Charities (Accounts & Reports) Regulations 2008. As of 31 December 2009 New Zealand had 24,319 registered charities (Charities Commission, 2009d) who were receiving NZD5.2 billion in income

per annum (Charities Commission, 2009f). By contrast the England and Wales Charity Commission has 160,515 charities and was receiving £52 billion in income (Charity Commission, 2009c).

The increasing significance of the charities sector in England and Wales was recognised by the creation of an 'Office of the Third Sector' in May 2006. One of its roles is to ensure policy and regulatory environment for the sector, is at an appropriate level (Office of the Third Sector, 2010). The Third Sector overlaps with charities as it includes NGOs and contrasts with the First Sector (For-Profit) and Second Sector (Public Sector). It remains to be seen what impact, if any, this cabinet office will have on the charities sector in England and Wales.

2.4.2.2 Conceptual framework

In England and Wales the pitiful state of charities' financial reporting was first highlighted nearly thirty years ago by Bird and Morgan-Jones (1981) who surveyed the published accounts of charities in order to identify their problems. This report led to the development of a discussion paper on charities by the Accounting Standards Committee (1984).

From this discussion paper the Charity Commission developed standards which ultimately have led to the publication of the existing Statement of Recommended Practice (SORP) by the Charity Commission (2005). This SORP was last updated in 2008 to allow for the Charities Act 2006. The present day SORP has been amended several times to take into account the variety of issues that several studies have uncovered (Ashford, 1986; Charity Finance Directors' Group, 2003; Connolly & Hyndman, 2000, 2001; Hines & Jones, 1992; Hyndman, 1990, 1991; Hyndman & Kirk, 1988; Palmer et al., 2001; Williams & Palmer, 1998). The SORP is also supported by the Charities (Accounts and Reports) Regulations 2008, which prescribes the form and content of charities' financial statements, including notes.

Meanwhile the Accounting Standard Board (ASB) has developed a Statement of Principles for Financial reporting for public benefit entities (Accounting Standards Board, 2007a). This statement sets out the principles the ASB considers underlie the preparation and presentation of general purpose financial statements for public benefit entities, including charities. Whilst the Charity Commission appears to be the driver for better standards rather than the accounting profession, this is misleading as although the ASB no longer prepares the SORP their influence over its continuing development is

considerable. This is reflected by their attendance at every SORP Committee meeting, and as well, the SORP must be approved by the ASB before it can be published (Hyndman & McMahon, 2010). This ensures that the SORP and the ASB's interpretation are compatible, further enhancing the charities sector's conceptual framework in England and Wales. Next the international conceptual frameworks and their applicability to the charities sector are considered.

2.4.3 International

There are two established international conceptual frameworks, one for the first sector (profit) and one for the second sector (public), which will be looked at next before investigating the gap in conceptual frameworks for the third sector which includes charities.

2.4.3.1 First sector – Profit making organisations

The International Accounting Standards Board (IASB) is the standard setting body of the International Accounting Standards Committee Foundation (Simpkins, 2006b). The IASB's principal objectives are to “*develop a single set of high quality, understandable, enforceable and globally accepted international Financial Reporting Standards (IFRSs)*” (International Accounting Standards Board, n.d., p. 1). The relevance of this sector to the Australia and New Zealand conceptual frameworks is that the standards developed by the IASB are currently utilised in Australia and New Zealand for their sector neutral conceptual frameworks.

2.4.3.2 Second sector - Public sector organisations

The International conceptual framework for the public sector (International Public Sector Accounting Standards Board, n.d.) is determined by the International Public Sector Accounting Standards Board (IPSASB) within the International Federation of Accountants (IFAC). IPSASB develop International Public Sector Accounting Standards (IPSAS) based on the IFRSs produced by the IASB, thus ensuring the convergence of both international frameworks. When developing new standards the IPSASB first looks at whether there is an appropriate IFRS and then determines whether identified public sector issues warrant departures from the IASB document (International Public Sector Accounting Standards Board, 2008b). It also modifies them to ensure that the standards can be more easily applied in the public sector, for example, through the use of sector specific examples (Controller and Auditor-General, 2009). In

certain cases there will be concepts in the public sector which have no equivalency in the for-profit sector, such as revenue from non-exchange transactions e.g. donations. If this is the case a separate standard will be developed (International Public Sector Accounting Standards Board, 2006). Schollum (2008) considers that more countries are likely to adopt IPSASs for use by their public sector entities which will increase the usability of these standards. As Perry (2009, p. 26), the chair of New Zealand's FRSB, states the "*IPSASB is at a stage where the standards being produced are of a sufficiently high level that they could be adopted in New Zealand*". The New Zealand Controller and Auditor-General expressed concern regarding the use of IFRSs for public benefit entities and considered that adopting IPSASs would improve the overall quality of financial reporting standards for public benefits (Controller and Auditor-General, 2009).

2.4.3.3 Third sector - Charities

A big gap in the international sector is the absence of any conceptual framework for charities or private NFPs. However, this has been acknowledged and members of the accounting standard-setting bodies in Australia, Canada, England and Wales and New Zealand have published a report (Australian Accounting Standards Board, Canadian Accounting Standards Board, Financial Reporting Standards Board, & Accounting Standards Board, 2008) that highlights the key NFP issues in the IFRS conceptual framework. In particular, there has been discussion on the decision-usefulness objective of financial reporting that needs to be broadened for charities and other NFPs to acknowledge the emphasis on accountability objectives (Australian Accounting Standards Board et al., 2008). Next, the regulatory and conceptual framework existing and proposed in New Zealand will be considered.

2.4.4 New Zealand

Whilst ahead of Australia in terms of specific regulation of the charities sector, compared to England and Wales New Zealand's regulatory framework for charities is in its infancy, with the first charities specific legislation enacted only in 2005.

As with Australia, New Zealand has had a series of working parties including:

- Property Law and Equity Reform Committee in 1979 (Newberry, 1994)
- The Working Party on Charities and Sporting Bodies (1989) which stated there should be a Commission for Voluntary and Welfare Agencies and Sporting Organisations;

- Working Party on the Accountability of Charities & Sporting Bodies (1997) which recommended the establishment of a Commission for Charities; and
- Two reports produced by the Working Party on Registration, Reporting and Monitoring of Charities (2002a, 2002b) which again recommended the establishment of a Charities Commission.

As well as the working parties the last 15 years has seen the establishment of umbrella organisations such as Philanthropy New Zealand formed by grant-making charities in 1995 (McLay, 2004). In 1999 the Office for the Community and Voluntary Sector (OCVS) was established, and in 2000 a Minister for the Community and Voluntary Sector was appointed, who currently is the co-leader of the Maori Party, the Hon. Tariana Turia.

Finally on 5 March 2003 the Minister of Finance announced that a Charities Commission would be established in 2004 (Working Party on Registration Reporting and Monitoring of Charities, 2003). To enable this to be achieved the Charities Act 2005 was enacted.

2.4.4.1 Regulatory framework

The New Zealand Government's intentions with the Charities Act 2005 is to build and maintain public trust and confidence in the charitable sector by making more information about charities publicly available (Gousmett, 2004). However Grant Thornton's NFP survey (2005) indicated that there is much scepticism amongst the sector about the Charities Act 2005. 52% of respondents were uncertain as to whether the Charities Act 2005 would be helpful and 49% were either uncertain, or disagreed, that they understood the Act and what it meant for their organisations. The organisation that is trying to overcome this public negativity is the Charities Commission, established under section 8 of the Charities Act 2005.

Section 10 of the Charities Act 2005 details numerous functions of the Charities Commission (Charities Commission, 2006a). In their Statement of Intent the Charities Commission aligns these functions with three outputs (Charities Commission, 2007b):

1. To register charitable entities in New Zealand;
2. To provide education and support to the charitable sector; and
3. To monitor the activities of charities.

The focus of the Charities Commission in its early years has been on the first function of registering charities. However, as the majority of organisations choosing to register as charities has decreased, so has the Charities Commission focus turned to their other two functions. In relation to the second function of education, the Charities Commission has stated that they are now “*scoping our ability to provide charities with access to education*” (Charities Commission, 2009b, p. 2). The Commission’s role in relation to monitoring charities has only recently been developed, as seen by recent headlines regarding the Charities Commission’s decision to de-register several charities, including Greenpeace, as their investigations determined that these charities existed for advocacy purposes, which is specifically excluded under section 5(2) Charities Act 2005 (Collins, 2010a, 2010b; Rudman, 2010). It is positive for the sector that the Charities Commission has become more proactive in its third role. Next, the registers in which some charities are listed are identified.

2.4.4.2 Registers

There are four registers in which charities can be registered: Charities Register; Charitable Trusts Register; Incorporated Societies Register; and Companies Register, all of which will be discussed next.

REGISTERED CHARITIES

Those organisations that the Charities Commission have approved for registration are listed on the Charities Register at <http://www.register.charities.govt.nz/CharitiesRegister/>. The potential success in regulating the charities sector hinges on ensuring that a substantial number of charities within the sector do register.

The Charities Commission is trying to encourage registration by emphasising the benefits for charities (Charities Commission, 2006b), which include the transparency of the Register as a depository for charities’ information that potential donors and funders can access. Also the mere fact of being registered ensures charities are exempt from income tax as per the Income Tax Act 2007 sections CW41 & CW42 (Charities Commission, 2006j).

Section 41 of the Charities Act 2005 requires each registered charity to file an Annual Return (Charities Commission, 2008b) each year. Question 25 of that return asks for specific financial information on income and expenditure; assets and liabilities and equity. This information is broken down into several categories, including: membership

fees; donations; grants; salaries and wages and investments (Charities Commission, 2006f). Question 25 also asks for a copy of the charitable entity's financial accounts for which there is no prescribed format (Charities Commission, 2009c). This means that charities can show similar information in different ways, thus limiting the comparability of charities.

However, whilst the Charities Register has only been open since 1st February 2007 (Charities Commission, 2006c; Inland Revenue Department, 2004) three other Registers have been operating far longer i.e. Incorporated Societies, Charitable Trusts and Companies Registers.

INCORPORATED SOCIETIES

The Incorporated Societies Register contains details of 21,500 organisations (Tennant et al., 2006). Section 18 Incorporated Societies Act 1908 requires that Societies not only give their name and registered office to the Registrar, but also under section 23 they must file certified financial statements on the societies register – see: <http://www.societies.govt.nz/cms>.

Certification requires that financial statements have been submitted to, and approved by, the members of the society at a general meeting (Ministry of Economic Development, 2008). Section 23(1) of the Incorporated Societies Act 1908 requires the following details: income, expenditure, assets, liabilities and all mortgages or charges affecting the property of the society within a given financial period. As with registered charities no prescribed format is given.

Those incorporated societies that have registered as charities are no longer required to file financial statements as they attach them to their Annual Return on the Charities Register and the Charities Commission follows up if this is not done. Unfortunately, with regards to the Incorporate Societies Register, the Registrar, in this case the Companies Office does not follow-up societies that fail to file their accounts, which limits the transparency of financial information with regards to incorporated societies.

CHARITABLE TRUSTS

There are 15,000 organisations (Tennant et al., 2006) on the charitable trust register – see: <http://www.societies.govt.nz/cms>. Section 11 of the Charitable Trusts Act 1957, states that Trusts must have their name and registered office on the register.

Unlike incorporated societies, the Charitable Trusts Act 1957 does not require charitable trusts to file financial statements with the societies register unless they are also a registered charity. Hence it is up to the individual charitable trust as to whether they make any financial statements available. However, case law, i.e. Bassett [1934] NZLR 690, requires an obligation on the trust to maintain proper records and accounts with, again, no guidance on GAAP stipulated (Arthur Cox & Centre for Voluntary Action Studies, 2002), which severely limits the transparency of information about charitable trusts, particularly the third of charitable trusts who have chosen not to register as a charity.

COMPANIES

When organisations register as companies their details will be available for public viewing on the Companies Register - see: <http://www.business.govt.nz/companies/app/ui/pages/companies/search>. The register holds the companies' key details including: addresses; directors; constitution; Annual Return; and financial statements.

Companies registered under the Companies Act 1993 must comply with the Financial Reporting Act for their financial reporting requirements. Section 11 of the Financial Reporting Act 1993 states that the financial statements must comply with GAAP and provide a true and fair view of the entity (Cordery, 2008).

2.4.4.3 Current conceptual framework

New Zealand follows a sector-neutral philosophy in that there is one set of GAAP requirements for all entities. New Zealand GAAP is based on the IFRSs produced by the IASB, reviewed by New Zealand Institute of Chartered Accountants (NZICA's) FRSB and approved by New Zealand's ASRB, and amended to ensure they comply with New Zealand conditions.

As IFRS requirements are quite arduous the NZICA has a process called 'differential reporting' which applies to Small-to-Medium Enterprises (SMEs). Organisations that are defined as SME have simpler GAAP requirements. NZICA's definition of SME is where two or more of the following criteria have been met (New Zealand Institute of Chartered Accountants, 2007a):

- total income under \$20 million;
- total assets of less than \$10 million; and
- fewer than 50 full-time equivalent employees.

All New Zealand reporting organisations were supposed to move to the New Zealand equivalent IFRSs by 2007. However, whilst New Zealand IFRSs have largely been adopted by large issuers and the public sector, the ASRB has postponed the adoption of IFRS for SMEs, which accounts for the majority of charities, until the financial reporting framework is reviewed (Accounting Standards Review Board, 2007b, 2009; Ministry of Economic Development, 2009d).

Therefore, New Zealand's GAAP for charities currently comprise two documents. First, the '*Not for Profit Financial Reporting Guide*' prepared by NZICA's Public Benefit working group (New Zealand Institute of Chartered Accountants, 2007a) which are based on New Zealand equivalent IFRSs. This guide is freely available on http://www.nzica.com/AM/Template.cfm?Section=Not_for_Profit_Financial_Reporting_Guide_and_Disclosure_Checklist. The decision to delay the introduction of IFRS standards for SMEs has meant that the previous guide, '*Research Bulletin R120 Financial Reporting by Voluntary Sector Entities*' (New Zealand Institute of Chartered Accountants, 1999), which is based on the old New Zealand Financial Reporting Standards, while dated is still relevant. Unfortunately, this guide is no longer available from NZICA.

This is not a very helpful state of events for people wishing to obtain guidance especially when Simpkins (2004) considers that the majority of NFPs, including charities, may not comply with GAAP. This assertion of non-compliance is supported by several New Zealand studies (Hooper et al., 2008; Newberry, 1992, 1995b; Not-for-Profit Sector Advisory Committee, 2009c; Rees & Dixon, 1983; Simpkins, 2003) which have identified numerous problems with charities' financial reporting. Compounding these problems was the study by Bradbury and Baskerville (2008) who found that a considerable amount of public benefit guidance has disappeared from GAAP and that the move to IFRS has slowed progress on public benefit financial statement issues, including those of charities. To save sector neutrality Van Peursem (2006, p. 1) considers there is a need for "*distinct standardisation where conceptual differences apply*". This has not happened to date, and Simpkins (2006b, p. 3) concludes "*a common conceptual framework will not be possible so long as the reluctance to make changes to ISAB documents evident in the recent past ... is maintained.*" Some of these identified problems that impact on transparency and understandability will be considered in *Chapter Three*. However, change is expected and this will be discussed next.

2.4.4.4 Future conceptual framework

New Zealand is currently on the cusp of a new era in the financial statements of charities with the release of a proposal from the Accounting Standards Review Board (ASRB) that proposes removing the existing sector neutrality system (Cordery & Baskerville, 2007) and replacing it with a sector specific, transaction neutral system (Accounting Standards Review Board, 2009). This was suggested in 1992 by Beechy and Zimmerman (1992) who considered that transactions should get the same accounting treatment regardless of whether they were for a business or a non-business entity.

Up to September 2009 New Zealand was in the same situation as Australia i.e. still in the ‘committee stage’, as there had been no further developments in financial reporting since the release in 2004 of the two Ministry of Economic Development reports (Ministry of Economic Development, 2004a, 2004b). NZICA’s response to those reports highlighted the need for a conceptual framework for charities’ reporting (New Zealand Institute of Chartered Accountants, 2005).

However, on 30 September 2009 the MED, the government department that has control over the Financial Reporting Act, and the ASRB, who approve financial standards, each published a discussion document on a proposed new statutory framework (Accounting Standards Review Board, 2009; Ministry of Economic Development, 2009d). As can be seen by *Table 2-1* (Cordery & Sinclair, 2009) the reports continued the tier-approach of the previous reviews’ reports (Ministry of Economic Development, 2004a, 2004b).

<i>Tiers Based Upon Operating Expenditure</i>	<i>Reporting standards proposed</i>	<i>Quality assurance proposed</i>
<i>Tier 1:</i> Operating expenditure \geq NZD10 million.	Full Public Benefit Entity Accounting Standards; a not-for-profit application of IPSAS. Expected to include financial statements and service reporting.	Audit
<i>Tier 2:</i> Publicly accountable entities (or those with \geq 10 members) with expenditure \leq NZD10 million but \geq NZD1 million. Entities with expenditure $<$ NZD1 million but \geq NZD20,000 which are issuers.	Differential Public Benefit Entity Accounting Standards based on above. Expected to include financial statements and service reporting.	Audit
<i>Tier 3:</i> Publicly accountable entities (or those with \geq 10 members) with expenditure \leq NZD1 million but \geq NZD20,000.	Simple Format Reporting based on accrual accounting. Expected to include financial statements and simple service reporting.	Review if expenditure \geq NZD100,000 and \leq NZD1 million. No audit or review if expenditure \leq NZD100,000
<i>Below Tier 3:</i> Equal to or Less than \$20,000	No reporting required	No assurance required

Table 2-1 Proposed Tiers of Accounting Standards to PBE Sectors (Cordery & Sinclair, 2009)

Barrington and Correll (2009) consider that NFPs need standards to ensure quality in their reporting. As can be seen from *Table 2-1* the detail of what constitutes ‘Public Benefit Entity Accounting Standards’ and ‘Simple Format Reporting’ has yet to be determined. Hence in order to improve the quality of charities reporting, the issues identified in past studies need to be resolved to enable quality reporting in the charities sector. This includes studies in New Zealand (Hooper et al., 2008; Newberry, 1992, 1995b; Not-for-Profit Sector Advisory Committee, 2009c; Rees & Dixon, 1983; Simpkins, 2003), England and Wales (Ashford, 1986; Charity Finance Directors' Group, 2003; Connolly & Hyndman, 2000, 2001; Hines & Jones, 1992; Hyndman, 1990, 1991; Hyndman & Kirk, 1988; Palmer et al., 2001; Williams & Palmer, 1998) and Australia (Dellaportas, Langton, & West, 2008; Ellwood & Newbury, 2006; Gurd, Palmer, & Wilson, 2008).

New Zealand’s conceptual framework, especially in relation to charities, is poised to make several changes over the next two years. Hopefully this will improve the charities sector by enhancing transparency with the availability of charities’ financial statements. All charities’ financial statements will be prepared by a regulated GAAP ensuring consistency in reporting charity by charity. Whilst this is promising, there are some

problems with New Zealand's regulatory and conceptual frameworks which are identified next.

2.5 Problems

There are two key problems with New Zealand's regulatory and conceptual framework. First, a pressing need for knowledgeable people to ensure the integrity of the charities sector and second, protection from the sector is being used to launder monies from nefarious acts such as terrorism. These problems will be discussed next.

2.5.1 Lack of knowledgeable people

One component of a regulatory framework operating effectively is knowledgeable people. The lack of knowledgeable people within the sector can be a problem as charities can often be let down by the very people who mean well but do not have the particular skills, such as financial management, that the charity is looking for (Siveter, 2004). In the United Kingdom specific reference was made to the calibre of the people preparing the financial accounts. Williams and Palmer (1998) felt that this was not of sufficient level to produce appropriate financial statements, particularly with small-medium sized charities. In Canada, PricewaterhouseCoopers (2009) has tried to alleviate this by providing grants of up to CAD5,000 for charities to spend on professional development.

For members of the NZICA there is self-regulation under their Code of Ethics. Rule 7 - paragraph 85 of the Code of Ethics (New Zealand Institute of Chartered Accountants, 2003a) states that "*a member who accepts or undertakes professional work must have the competence necessary to carry out the work*". However, not all the people performing book-keeping duties are members of NZICA. Also the Code relies on self-regulation and some NZICA members are not always honest about their own abilities, or lack of them. This research seeks to identify why people record things in certain ways and whether it is lack of knowledge that causes their action, or inaction in some situations.

2.5.2 Terrorism funding

One problem with charities is how to distinguish between monies used for charitable purpose and monies used to fund illicit activities such as terrorism. The European Parliament (2005) has considered this as it is concerned that massive flows of 'dirty money' can not only damage the conduit, such as charities, through which the money is

filtered, but also the stability and reputation of the financial sector. The importance of this issue was recently seen in New Zealand in February 2010 with the publication of a fact sheet which seeks to raise the awareness of the issue and ways in which charities can act to ensure no money from terrorist activities is 'laundered' through their charity (Charities Commission, 2010a).

The problem is then how regulatory frameworks can ensure that dirty money is not filtered through charities. The European Commission has passed guidelines (European Commission, 2005b) that they hope will protect the charitable sector against the threat of exploitation for the financing of terrorism (Dochas, 2006). The European Foundation Centre (2008) has reviewed these measures and cautioned against the use of risk profiling for public benefit organisations. It considers that there needs to be continued dialogue to assess the impact of the counter-terrorism measures on organisations in the charitable sector.

One problem is that charitable funds can be mingled with the funds for terrorist operations. This makes it difficult for governments to act without causing widespread complaints that they are "*seizing money destined for good works*" (Rosenberg & Simpson, 2008, p. A8). This is seen in the case of the Pakistani charity 'Jamaat', which has made substantial humanitarian efforts (Rosenberg & Simpson, 2008). Dogar and Shahzad (2008) highlight the case of a Jamaat facility in Pakistan which includes a school and 100-bed hospital, whose funding had now been frozen, putting at risk all the social benefit gained from the operation. As Tupman (2009, p. 189) points out "*the funds seized were not primarily for terrorist funding and the seizure has done more harm than good*".

With charities just a rumour of illicit use implicates the whole charity. In England in 2008 Newsnight used the inflammatory title '*BBC's Children in Need funded 7/7 terrorist propaganda*' to capture the public's attention (Hope & Gardham, 2008). Of the GBP30 million given each year by the charity 'Children in Need' to various organisations, GBP20,000 i.e. 0.067% was handed over in 1998 and 1999 to a bookshop suspected of having links to terrorists. However, further investigation found no evidence of the money being used for terrorist activity (Hope & Gardham, 2008). In fact, Social Platform, an alliance of European NGOs, reports a study that found "*the incidence and prevalence of NPO [Non-profit organisations] financial abuse in the European Union are limited*" (Social Platform, 2008, p. 1). Public perception means that charities must be proactive to ensure that terrorism funding does not take place.

This research seeks to identify if there is clarity in reporting, material amounts of the charities' monies being used, or coming from, nefarious acts will be highlighted. Next, the role monitoring by charities' regulatory bodies, taxation agencies, funders and rating agencies, plays in ensuring compliance with regulatory and compliance frameworks is reviewed.

2.6 Monitoring

Andreoni (1990) talks about the 'warm glow' donors feel from giving, or as one donor said "*I gave money away almost for selfish reasons – you get a lot of pleasure from doing it*" (Collins, 2009, p. A2). This pleasure potentially vanishes upon the revelation of fraud within the organisation.

Although, there is an assumption that people involved in charities are altruists this is not always the case and the media is full of articles on fraud in charities. For example, a charity finance man receiving thirty-three months imprisonment for stealing from a cerebral palsy charity in England (Anonymous, 2008a). Also the Methodist Mission in New Zealand discovered NZD160,000 had been stolen from the social welfare benefits of their beneficiaries (Cordery & Baskerville, 2005).

The media exacerbates the concerns about misappropriation by using emotive language and headlines that gain high media coverage, such as that seen in the Exempt Organization Tax Review '*Pillaging of Charitable Assets: Embezzlement and Fraud*' (Fremont-Smith, 2004), and by appealing to the readers directly '*Charities missing out on your donations*' (Television New Zealand, 2009).

Fisher (2006b) comments that fraud is more prevalent in charities than in for-profit organisations. This was supported by the Organisation for Economic Co-operation and Development (OECD) who found that "*some countries estimate that the abuse of charities costs their treasury many hundreds of millions of dollars and is becoming more prevalent*" (Organisation for Economic Co-operation and Development, 2008, p. 2). Palmer and Randall (2002) consider that this is due to the fact that charities depend on trust rather than the internal controls usually prevalent in commercial operations. However, BDO International's latest NFP fraud survey of 384 respondents from NFPs, including charities, in Australia and New Zealand contradicts this (BDO International, 2008). Whilst, two-thirds of respondents considered that fraud was a problem in the NFP sector only 16% had suffered a fraud in the previous two years, indicating that the

perception of fraud in the NFP sector is different from the reality. Thus, while a certain level of fraud can be expected of commercial organisations the trust inherent in charities means that any fraud is not acceptable to donors.

There is also a concern that people may establish charities to avail themselves of the taxation benefits. Hence, there is a need for charitable organisations to be monitored to ensure they still meet the charitable purpose definition and any anomalies are investigated. Issues around monitoring will form part of this study of reporting by New Zealand charities. Next, the various organisations that monitor charities will be reviewed starting with charities' regulatory bodies.

2.6.1 Charities' Regulatory Bodies

Once a charity is registered, the Charities Commission is able to monitor its activities and, in particular, investigate complaints (Charities Commission, 2007b). The Charities Commission's 2008 Annual Report states that a framework has been developed for monitoring activities (Charities Commission, 2008a).

Chris Winstanley, the Charities Commission's General Manager of Registration and Compliance, has noted that at this stage the framework is exception driven rather than examining every charity. Thus, if someone complains about a charity the Commission will investigate. This has already seen the removal from the register of some charities that no longer meet the requirement of charitable purpose or have pecuniary gains (Personal Communication, 13 May 2009).

This focus on investigating complaints about charities was reiterated by Trevor Garrett, the Commission's Chief Executive, who was interviewed on 'Close-up' (Television New Zealand, 27 July 2009) and stated:

You're [the public] the ones that are going to put it [charities] under scrutiny and if there's any issues of real concern, you'll come to us [Charities Commission] and say hey, we've got a problem and we will carry out an investigation into that organisation.

When the interviewer responds by asking "your job is to monitor this stuff. Shouldn't you be assessing charities?" the Chief Executive notes that with 23,000 organisations registered they are unable to look at every single organisation.

However, in England and Wales the Charity Commission is much more proactive and considers that "having a regulator that deals swiftly and effectively with abuse when it occurs and promotes compliance is at the heart of public trust and confidence in

charities” (Charity Commission, 2008b, p. 3). This is embedded in section 7 of the Charities Act 2006.

One example of the England & Wales Charity Commission fulfilling their objective is seen in their publication – ‘*Charities Back on Track – Themes and lessons from the Charity Commission’s compliance work*’. This report highlights the issues identified during the Commission’s compliance work in 2007 and 2008. The key issues were: (1) Vulnerable beneficiaries; (2) Governance, and (3) Accounting and reporting (Charity Commission, 2008b). This study will consider whether these issues on governance, in relation to accountability, and reporting are relevant in the New Zealand environment. Next, taxation agencies and the role they play in monitoring charities is considered.

2.6.2 Taxation Agencies

Many taxation administrations have a statutory responsibility to ensure compliance with the eligibility requirements for taxation relief. Their role is to ensure that the tax relief and tax benefits are appropriately claimed (Organisation for Economic Co-operation and Development, 2008).

In England, Her Majesty’s Revenue and Customs (HMRC) Agency has responsibility for the tax affairs of all charities (whether registered or not) and donors (Organisation for Economic Co-operation and Development, 2008). In Australia the Australian Taxation Office (ATO) determines eligibility for DGR (Deductible Gift Recipient) and charitable status. The HMRC, along with the Charity Commission, actively investigates organisations that appear to be breaching their eligibility. By contrast Australia does not appear proactive in investigating anomalies in charitable organisations, possibly as a result of having forty statutes and nineteen agencies that determine charitable status or provide taxation concessions (Productivity Commission, 2009).

In New Zealand, the Inland Revenue Department has responsibility for awarding donee organisation status and taxation concessions. However, since 2007 the Charities Commission has taken responsibility for granting income tax exemptions over registered charities. The Working Party on Charities and Sporting Bodies (1989) highlights the shortcomings of the New Zealand taxation system with regards to the avoidance of taxation through the use of charitable exempt status and failure to detect abuse. They consider this a direct consequence of the Inland Revenue Department’s not pursuing a policy of requiring returns from taxation-exempt bodies or investigating compliance. The Attorney-General does have the authority under section 58 of the

Charitable Trusts Act 1957 to examine and inquire into all or any charities in New Zealand, including charitable trusts. However, this authority does not appear to have been utilised and although the New Zealand's Charities Commission monitors registered charities, these are only a small portion of the NFP organisations that receive taxation benefits. Whilst an analysis of wider NFP moderation is outside the scope of this research, this study will consider the monitoring in terms of the accountability of charities for tax foregone. Next, funders, and the conditions they impose on charities they fund to monitor the charity's use of the funds, is considered.

2.6.3 Funders

Many charities spend a considerable amount of time pursuing funding (Association of Non-Governmental Organisations of Aotearoa, 2009). New Zealand has several large funding bodies, both governmental, including; the Department of Health's Disability Information Advisory Service (DIAS), the Department of Internal Affairs' Community Organisation Grants Scheme (COGS) and the New Zealand Lottery Grants Board; and non-governmental, including ASB Community Trust, JR McKenzie Trust and the Lion Foundation.

There are a number of conditions that charities need to fulfil in order to obtain and keep funding. Of these there are three reporting requirements usually demanded by funders from charities they fund. First, funders usually want to see their contribution shown separately in the financial statements as an acknowledgement of the support the funder has given the charity.

A second condition is the requirement for internal verification, that is, ensuring the money charities received from funders is appropriately spent. Also, funders can sometimes require external verification, such as audits, as Fisher (2007a, p. 23) highlighted "*Many funders require audited financial statements as a condition of their funding*". However, obtaining an audit can be quite costly for small charities and at times cost more than the charity ultimately received from funders (Fisher, 2007a).

The final requirement involves charities' needing to complete funders' special reporting forms and these can vary from funder to funder. Charities that receive a large portion of their funds from large philanthropic donors will generally be compelled to produce the type of information that complies with their funders' requirements. This means that many charities are having to provide the same information contained in financial

statements in different documents to each of their funders (Hyndman & McDonnell, 2009). Next, the potential role rating agencies play in monitoring charities is investigated.

2.6.4 Rating Agencies

Rating agencies obtain and interpret accounting data and other information about charities and report their analysis, in the form of ratings, to help donors select among the many organisations soliciting contributions (Gordon, Knock, & Neely, 2009). Several organisations have emerged to help donors compare and review charities (Association of Fundraising Professionals, 2009b).

Rating Agencies have mainly been utilised in the United States and include: Charity Navigator (<http://www.charitynavigator.org/>); BBB (Better Business Bureau) Wise Giving Alliance (<http://www.bbb.org/us/>); and GuideStar (<http://www2.guidestar.org/>). In the United States, charities' financial information is available through the United States' Taxation agency, the Internal Revenue Service's form IR 990 (Internal Revenue Service, 2008) which can be viewed at various sites including <http://foundationcenter.org/findfunders/990finder/>. Gordon, Knock & Neely (2009) consider that rating agencies can be of benefit to potential donors due to the availability and ease of use compared to the donor's accessing a Form 990 and computing ratios for themselves. Next, some of the ratios calculated by the three main rating agencies are considered.

Charity Navigator (2009) in the United States of America (USA) consider that their ratings provide reliable assessments of the organisational efficiency i.e. spending less than they raise and the financial health of charities. The information used to calculate ratios is obtained from the Charities' IR990. Organisational efficiency, i.e. output, ratios include: programme expenses; administrative expenses and fundraising expenses against total expenses. Ratios on financial health include the working capital ratio i.e. how long a charity can sustain its current programmes without generating new revenue (Charity Navigator, 2010).

The BBB Wise Giving Alliance in the USA also includes ratios focused on outputs that specify what standard is appropriate for the ratios, including the need for the charity to spend at least 65% of its total expenses on programme activities and spend no more than 35% of related contributions on fund raising. It also ensures that the charity spends their

funds by limiting their unrestricted funds to three times the size of the past year's expenses (BBB Wise Giving Alliance, 2003).

Whilst, the previous two rating agencies are based in the USA the third rating agency, GuideStar since 2003 also operates in England and Wales (<http://www.guidestar.org.uk>) where it contains details of 169,000 registered charities. In England and Wales the base information about each charity is provided from the records of the Charity Commission. Unlike the previous two rating agencies GuideStar UK does not evaluate charities or comment on their performance but they focus on reporting basic information such as: how the charity spends its money and the charity's activities and recent achievements.

By contrast Australia and New Zealand currently have no rating agencies although their merits have been highlighted in Australia where the Senate Standing Committee on Economics recommended an investigation on the merits of a rating system's publishing information on the aims and activities of NFPs (Senate Standing Committee on Economics, 2008). In New Zealand the advantages of a rating agency's providing detailed information was highlighted by Philanthropy New Zealand in their submission to the Tax and Charitable Giving Project (Philanthropy New Zealand, 2006). However, at the time of writing the researcher is not aware of any more developments regarding setting up a rating agency in Australia and New Zealand

Ratings agencies could provide a forum for donors to access information that may help them in their decision as to which charity to donate to. However, for rating agencies to be successful in comparing charities financial statements, they need a common conceptual framework in which all charities operate.

2.7 Summary

This chapter has reviewed the issues caused by the myriad of definitions and legal structures that beset the charities sector in order to gain an appreciation of what constitutes the charities sector. As well, an appreciation of the regulatory and conceptual frameworks was developed of the charities sector in New Zealand, as well as our nearest neighbour Australia and two countries with a similar regulatory body, England and Wales.

With regards to the regulatory and conceptual frameworks, two key problems were identified that impair the ability of regulators to facilitate transparency and accountability of the monies received from donations or tax concessions. This study will

seek to identify whether a lack of knowledgeable people impacts on the financial statements of charities and whether there is a need for reporting that clearly shows the activities of the charity and lessens the ability for charities to be used to fund terrorism and other illicit activities.

Next, the role monitoring by charities' regulatory bodies, taxation agencies, funders and rating agencies, plays in ensuring compliance with regulatory and compliance frameworks is considered. The effectiveness, or otherwise, of the monitoring will potentially impact on the research and will be discussed in subsequent chapters. The next chapter highlights some key issues impacting transparency and understandability of the conceptual framework.

CHAPTER 3: TRANSPARENCY & UNDERSTANDABILITY

3.1 Introduction

The importance of transparency and understandability was highlighted by Fletcher (2008), in an unpublished New Zealand study of funders, who found that participants considered that financial statements should be transparent and easy to understand by a 'lay person'. This importance was reinforced by the New Zealand Charities Commission which states that an effective charity:

Understands that the public has a valid interest in it, and manages its accountabilities to its stakeholders and to the public in a way that is timely, transparent, and understandable (Charities Commission, 2009e, p. 3).

The premise for this research is that financial information and consequently the financial statements of charities are not always understandable or transparent. In particular, complexities exist in the preparation of charities' financial statements which hinder transparency and understandability.

This chapter will initially look at the meanings behind transparency and understandability and the impact they have on reporting, before focusing on four particular complexities in transparency and understandability that impact the financial statements. The four complexities are in relation to the choice of accounting basis, the measurement of property, plant and equipment, aspects of fund accounting and the reporting of expenditure overhead ratios. Next, transparency and its impact on the financial statements are considered.

3.1.1 Transparency

England and Wales's Charity Commission interprets transparency as:

Providing relevant and reliable information to stakeholders in a way that is free from bias, comparable, understandable and focused on stakeholders' legitimate needs (Charity Commission, 2004, p. 2).

Transparency of reporting is becoming increasingly important in the management of charitable organisations as funding bodies and the wider public demand evidence of efficient stewardship of the funds they donate (Charity Commission, 2004). This importance is seen in Australia, where PricewaterhouseCoopers supports the 'NFP PwC Transparency Awards' which recognises best practice reporting in the NFP sector (Institute of Chartered Accountants in Australia, 2009b) and the awards importance was recognised by Senator Stephens, the Australian Parliamentary Secretary for Social Inclusion and the Voluntary Sector (Stephens, 2009).

In the international arena transparency is considered an important tool to prevent charitable organisations being used to fund terrorists, as detailed in *Chapter Two section 2.5.2* (European Commission, 2005b). The European Commission has recognised that there is a need to protect the charities sector by imposing higher standards of transparency (European Commission, 2005a).

The importance of transparency for the wider public is illustrated in a newspaper editorial (Editorial, 2009, 16 August, p. 45) which states:

Making a charitable donation is about as discretionary as spending gets; the least the charities owe their supporters is transparency.

As New Zealand's registered charities now provide public access to their financial accounts through their Annual Return, Trevor Garrett, the CEO of the New Zealand Charities Commission, says in his Annual Report that:

Comments we receive indicate that people value the increased transparency of the charitable sector that the [Charities] register enables (Charities Commission, 2008a, p. 5).

However, in an interview on Radio New Zealand (27 August 2009) he touches on the negative side of transparency:

Many of those charities have never made information about themselves public, which is a pity, because ... there should be a relationship between the charity and the people giving the money. But as people start to look at those accounts, they're going to start to ask questions.

Brandeis (cited in Fishman, 2007, p. 123) said in 1914 that “*sunlight is the best disinfectant*”, which implies that ‘opening the books’ will provide more transparency for contributors of charitable organisations. However, this assumes that these financial accounts are transparent to all stakeholders. Unfortunately, previous studies in England and Wales (Accounting Standards Committee, 1984; Ashford, 1986; Bird, 1985; Bird & Morgan-Jones, 1981; Charity Commission, 2004; Connolly & Hyndman, 2000, 2001, 2004; Hines & Jones, 1992; Hyndman, 1990, 1991; Lee, 2003; Williams & Palmer, 1998) and New Zealand (Hooper et al., 2008; Narraway & Cordery, 2006; Newberry, 1992, 1995b; Rees & Dixon, 1983) have shown that this is not the case and that there are some complexities that veil the transparency of the financial accounts of charities. In particular, one aspect of transparency that has raised questions is the understandability of charities’ financial statements, considered next.

3.1.2 Understandability

Trevor Garrett, the Chief Executive Officer of the Charities Commission, considers that (Garrett, 2010, p. 1):

It is vitally important that registered charities keep the information on their Register pages accurate and easily understandable.

In relation to understandability it is important to comprehend its context within the conceptual framework especially with regards to the presentation of charities' financial statements (International Accounting Standards Board, 2008b; International Public Sector Accounting Standards Board, 2008a). The International Accounting Standards Board in their publication '*Preliminary Views of Financial Statement Presentation*' considers that the presentation of financial statements are important as they are the principal means of communicating financial information to those outside an organisation (International Accounting Standards Board, 2008e). Of particular importance in reporting are the six qualitative characteristics of information, i.e. relevance, comparability, understandability, timeliness, faithful representation and vulnerability that makes that information useful to users (Governmental Accounting Standards Board, 2009; International Public Sector Accounting Standards Board, 2008a).

Of the six qualitative characteristics, a study of user needs focused on the first three characteristics, as the study identified that the important needs of users are the furnishing of "*relevant, comparable and understandable financial statements*" (Connolly & Hyndman, 2000, p. 97). These three qualitative characteristics will be focused on next. The first two characteristics, relevance and comparability, will be looked at to determine their meaning and their linkage to understandability, before focusing on the importance of understandability in producing quality financial statements.

RELEVANCE

The International Public Sector Accounting Standards Board (2008a) considers that information is relevant if it is capable of making a difference in the decisions made by the users. In this study relevance is used in the context of donors choosing which charity to donate to and deciding what is the relevant information that they need to support their decision. An important aspect of relevance in this context is ensuring that the relevant information is understandable to donors, as without understandable information

relevance is compromised. The link between ‘comparability’ and ‘understandability’ and ‘transparency’ is looked at next.

COMPARABILITY

Comparability enables users to identify similarities and differences between charities’ financial statements (International Accounting Standards Board, 2008b). It is based on the premise that information about a charity is more useful if it can be compared with similar charities (Accounting Standards Board, 2007a).

Comparability implies consistency throughout the reporting process i.e. in both the recording of information such as property, and the reporting of that information in financial statements. New Zealand’s Controller and Auditor-General emphasises the importance of comparability in the financial statements by saying:

To be comparable, the reports should: be consistent in their format, layout, and in the way information is classified; be consistent in the selection, measurement, and disclosure of elements and related information (Controller and Auditor-General, 2008, p. 49).

The importance of comparability in the charities sector was highlighted in a study of 1,000 people where “*over 60% of participants said that the ability to compare important information between charities would affect their decision about which charity to support*” (Framjee, 2004, p. 89). In Australia comparability was also considered one of the fundamental principles needed for effective transparency (Institute of Chartered Accountants in Australia, 2009a).

Young (2006, p. 583) puts the lack of comparability at the feet of the accounting profession by considering that “*the lack of comparability arose from the failure of accountants to specify a single accounting method for such basic areas as ... depreciation.*” This was supported in England by the Accounting Standards Board predecessor, the Accounting Standards Committee, who considered that the number of diverse practices in reporting adopted by charities is confusing and can be misleading to the readers of charities’ financial statements (Accounting Standards Committee, 1984). Thus an important aspect of comparability is a prescribed conceptual framework which needs to ensure consistent GAAP is used by all charities. Next, the importance of understandability is reviewed.

UNDERSTANDABILITY

Understandability is the quality of information that enables donors to comprehend its meaning (International Accounting Standards Board, 2008b). The concept of

‘understandability’ is at the very root of GAAP. The New Zealand Controller and Auditor-General in paragraph 5.11 states:

The overall objective for the standard setter in setting New Zealand standards should be to set high-quality standards designed to produce general purpose financial statements that are understandable and meet the needs of the people using them (Controller and Auditor-General, 2009, p. 54).

This view is supported by numerous standard setters including that of the USA where the objective of their Statement of Financial Accounting Standards No. 117: Financial Statements of Not-for-Profit Organizations is to:

Enhance the relevance, understandability, and comparability of financial statements issued by those organizations (Financial Accounting Standards Board, 2008b, p. 1).

The English Accounting Standards Board (2007a, p. 27) consider that understandability is dependent on the way in which transactions are “*characterised, aggregated and classified*” and information is shown. However, they acknowledge that it is not always possible to present information in a way that can be understood by all users (Accounting Standards Board, 2007a). In fact, the IFAC highlight that while the reliability of financial statements may have increased, the understandability of financial statements has not improved much (International Federation of Accountants, 2009a). This may be because accounting standards are written in accounting language that may not be easily understood by non-accountants (Palmer & Randall, 2002).

In New Zealand this lack of understandability in financial statements was highlighted in the media by Rick Shera, a charity chairman, who said “*it is difficult to look at accounts and understand what they say*” (Television New Zealand, 12 August 2009). He further reiterated that there was a need to make financial statements “*intelligible to an accountant, never mind the average punter*” (Editorial, 2009, 16 August, p. 45).

Jetty and Bettie’s (2009) study found that there are still inconsistencies in the reporting practices of charities, which supports the findings of earlier studies (Connolly & Dhanani, 2009; Connolly & Hyndman, 2004; Hyndman, 1990, 1991). Reporting by charities is characterised by a diversity of accounting practices and a lack of standardisation which has resulted in difficulties for users in understanding charities’ financial statements (Connolly & Hyndman, 2003). The impact these diverse accounting practices have made on charities’ financial statements and the resultant complexities in charities’ financial statements will be considered in the next section.

3.2 Complexities in Charities' Financial Statements

There is a prevailing view that financial statements in the charities sector are simple and that financially managing a charity is not as complex as managing commercial organisations (Palmer & Randall, 2002). However, this is often not the case in relation to the financial reporting of charitable organisations as, despite the economic importance of the charities sector, external financial reporting has been characterised by a diversity of accounting practice and a lack of standardisation, which have made it difficult for users to understand financial statements (Connolly & Hyndman, 2001). Furthermore, it has been suggested that a general lack of expertise of trustees, treasurers and auditors in the charities sector results in substandard financial statements (Connolly & Hyndman, 2001). This supports William and Palmer's (1998) view that knowledge of the people preparing the financial statements is not of a sufficient level to produce appropriate financial statements.

In New Zealand, the question of whether NZICA's emphasis on one set of standards, i.e. sector neutrality, is appropriate for the charities sector has also elicited much discussion (Carson, 2008; Cordery, 2006, 2007). For a conceptual framework to work it is important that the specific reporting concerns of all sectors, including charities, are identified and resolved. However, Simpkins (2006a) considers that New Zealand's focus on sector neutrality has failed to identify and analyse the differences between the 'for-profit' and 'not-for-profit' sectors.

Early researchers in the USA and England (Anthony, 1978; Bird & Morgan-Jones, 1981) found numerous complexities with the financial statements of charities. Research in New Zealand to support the lack of compliance has been limited. One of the first studies was by Rees and Dixon (1983) who surveyed 273 treasurers and reviewed 123 financial statements to evaluate financial reporting practices. The problem areas that they identified included: fund accounts reporting; the treatment of donations; donated property, plant and equipment; and lack of disclosure about specific costs.

In the subsequent decade Newberry (1992) reviewed the financial statements of 29 charities. Her findings highlight complexities in complying with GAAP, especially in relation to accounting for donations and funds. More recent work was done by Hui (2006), published as Hooper, Sinclair, Hui and Mataira (2008), with eight respondents, who confirmed that the complexities identified by previous researchers were still relevant today (Bird & Morgan-Jones, 1981; Newberry, 1992; Rees & Dixon, 1983).

Whilst these complexities have already been identified there is a lack of understanding as to why these complexities still exist. Could complexities be clarified through a prescribed conceptual framework or are there other reasons that cause these complexities to still exist thirty years after first identified by Bird & Morgan-Jones (1981)?

This research will analyse the four complexities, identified by Hui (2006), that still impact on the transparency and understandability of financial statements in the New Zealand charities sector. These relate to complexities with the accounting treatment within the financial statements particularly, on the accounting basis, the recording of property, plant and equipment, fund accounting, and reporting expenditure overhead ratios. For each complexity two aspects will be considered. First, the appropriate accounting treatment will be looked at in terms of what is the appropriate GAAP, and second, a review of what studies have found with regards to complexities with transparency and understandability will be considered for each of the complexities.

When considering what is the appropriate GAAP for these complexities several sources will be utilised. First, as this study focuses on New Zealand charities, the two New Zealand guides – ‘*Not for Profit Financial Reporting Guide*’ (NFPFRG) which is based on the IFRS (New Zealand Institute of Chartered Accountants, 2007a), and the R120 Financial Reporting by Voluntary Sector Entities based on the old New Zealand Financial Reporting Standards, (New Zealand Institute of Chartered Accountants, 1999) described in *Chapter Two, section 2.4.4.3*, will be considered. Also it is appropriate to include England and Wales’ Statement of Recommended Practice (SORP) (Charity Commission, 2005). This is because, as well as having a specific Charity GAAP, unlike Australia and New Zealand, England and Wales has had extensive research (Accounting Standards Committee, 1984; Ashford, 1986; Bird & Morgan-Jones, 1981; Charity Commission, 2004; Connolly & Hyndman, 2000, 2001, 2004; Framjee, 2004; Hines & Jones, 1992; Hyndman, 1990, 1991; Palmer et al., 2001; Palmer & Randall, 2002; Williams & Palmer, 1998) on these complexities and incorporated these findings into their SORP (Charity Commission, 2005).

The first of the complexities in transparency and understandability in the financial statements relating to the accounting basis, will be considered next.

3.2.1 Accounting basis

The 'Accounting basis' refers to how transactions are recorded in an organisation. There are three main types of accounting bases: (1) accrual basis; (2) cash basis and (3) modified accrual accounting. Under the accrual basis, the effects of transactions and other events are recognised when they occur. The time that transaction occurs may or may not coincide with the time that cash is received or paid (New Zealand Institute of Chartered Accountants, 1993). This is unlike the cash basis where transactions are recorded only when the money is received or paid. The modified accrual basis is where expenses are recorded when they occur, and revenue e.g. donations, when they are received. The complexity arises with regards to when it is appropriate to use each different accounting basis. GAAP prescribes some situations when certain accounting bases should be used, and this will be looked at next.

3.2.1.1 GAAP

R120 paragraph 2.3.4 (New Zealand Institute of Chartered Accountants, 1999) requires that the accrual basis be used, rather than a cash basis, with two exceptions to this rule. Firstly pledges, which are an undertaking to donate money (Penguin, 2000), as per paragraph 3.45 are not normally recognised until the cash is received, because there is doubt over the likelihood of the pledge being honoured. The second exception is where donations are collected by other parties on behalf of a charity. These will be accrued when the money is collected (paragraph 3.44) unless there are no reliable estimates of the amounts collected. In this case the transaction is recorded when the money has been received. This highlights the third type of measurement – the modified accrual basis.

NFRFRG (New Zealand Institute of Chartered Accountants, 2007a) has a similar ruling with regards to accrual basis (paragraph 3.16) and pledges (paragraph 5.55). However, NFRFRG is more specific in relation to donations, as it acknowledges that donations are usually at the discretion of the donor so it is more appropriate to record them when the donation is received (paragraph 5.35), i.e. to use modified accrual accounting as per R120. This ensures that for donations the criteria are whether there is 'certainty' that the donations will be received, and the donations are able to be measured. If there is certainty of receipt, e.g. under a binding agreement, then Exposure Draft 118 Income from Non-exchange Transactions (Taxes and Transfers) states that it should be recognised as income (Australian Accounting Standards Board & Financial Accounting Standards Board, 2009) which comes from IPSAS23 paragraph 95: "*when it is probable that the future economic benefits or service potential will flow to the entity and the fair*

value of the assets can be measured reliably”(International Public Sector Accounting Standards Board, 2006).

In England and Wales the accounting basis is dependent on the size of the charity, with small charities who are not companies (<GBP250,000 income) being allowed to use cash basis rather than accrual basis (Charity Commission, 2009f). For other charities, the SORP paragraph 60 states that accounts intending to show a true and fair view must be prepared under the accruals concept (Charity Commission, 2005).

In New Zealand an initial proposal on possible financial reporting requirements (Ministry of Economic Development, 2004b), followed England and Wales by suggesting that small charities (<NZD100,000) use cash basis (*Table 3-1*).

	<i>Income</i>	<i>Possible reporting requirements</i>
<i>Tier 1</i>	Greater than NZD2.5 million	Accrual accounting
<i>Tier 2</i>	From NZD100,000 to NZD2.5 million	Accrual accounting
<i>Tier 3</i>	Less than NZD100,000	Receipts and payments

Table 3-1 2004 proposals (Ministry of Economic Development, 2004b)

However, the recent proposals (Accounting Standards Review Board, 2009; Ministry of Economic Development, 2009d) have moved away from England and Wales’ position on the cash basis and suggest that all three tiers use accrual accounting (*Table 3-2*). This reflects, in the last few years, the move away from cash methods as the basis of accounting to accrual (International Federation of Accountants, 2008). The recent proposals also suggest that operating expenditure, rather than income, be used. This is because the ASRB (Accounting Standards Review Board, 2009) consider that charitable organisations are predominantly expenditure rather than income driven.

	<i>Operating expenditure</i>	<i>Possible reporting requirements</i>
<i>Tier 1</i>	Greater than NZD10 million	Accrual accounting
<i>Tier 2</i>	From NZD1 million to NZD10 million	Accrual accounting
<i>Tier 3</i>	Less than NZD1 million and greater than NZD20,000	Accrual accounting

Table 3-2 MED 2009 proposals (Accounting Standards Review Board, 2009)

An interesting point is that New Zealand’s Annual Return form for charities (Charities Commission, 2008c) has boxes only for cash and accrual, not modified accrual. This means that most charities that have donations should be ticking both boxes. The

application of the appropriate GAAP amongst charities in this study will need to be assessed to determine whether the appropriate accounting basis is used, according to GAAP. Next, studies relating to the accounting basis and when it is appropriate to use the different types will be considered.

3.2.1.2 *Studies*

In New Zealand, Rees and Dixon's (1983) study found that 55% of NFPs, including charities, practiced cash accounting and 45% accrual accounting - no mention was made of modified accrual accounting. This contrasted with Hooper, et al.'s more recent New Zealand study (2008) where 62% used modified accrual accounting basis. However, the remaining interviewees (38%) opposed the use of a modified accrual basis as they considered that only an accrual basis can reflect a true and fair view of the charity's financial results and position (Hooper et al., 2008).

However, an accrual basis is not always appropriate with regards to pledges. The media is full of examples of organisations that have been pledged monies which they have never received. One example is from Afghanistan, which have not received USD10 billion (approximately NZD14 billion) in aid (Anonymous, 2008d). Another example is with regards to monies pledged for the tsunami relief fund, where the United Nations' disaster relief coordinator has said that only a tenth of the NZD3.4 billion dollars pledged was actually received (Radio New Zealand, 12 January 2005). These examples highlight the importance of charities not recording pledges until they have actually been received i.e. there is certainty of receipt, which is what is recommended GAAP. This supports Anthony's (1993, p. 55) view that a pledge to contribute funds should not be classified as revenue in the year in which the pledge was received as "*pledges that promise payments ... are not revenues in any sound accounting system*". For, as Granof (2007, p. 492) highlights, "*NFPs generally lack legally enforceable claims against fickle donors*". In relation to the accounting basis, the concern here is the certainty of receipt i.e. how enforceable the promise is, or how certain is the receipt of monies.

Another concern of the accounting basis is in relation to the matching concept. The matching concept is where income is matched with the expenditure needed to produce that income. Unfortunately, charities' income does not necessarily relate to the expenditure. Any consideration that might be received for the service to the beneficiary is unlikely to be related to the amount of resources, e.g. expenses, provided. Ashford (1986, p. 18) felt that "*the lack of an output measure makes any suggestion of matching*

output and input cost rather meaningless”. Contradicting this was Khumawala and Gordon’s (1997) study whose participants considered that donations were earned, i.e. matched, when the money was used for the designated purpose and not upon receipt, as required by GAAP.

The two concerns with the accounting basis complexity that this study will investigate are in relation to, first, the certainty of receipt, with regards to when to record pledges, and second, whether the matching concept is valid for charities. This research will also determine whether these two concerns are still occurring in charities and ascertain which accounting basis charities use. If the concerns occur in the charities, the study will also determine why charities use, or do not use the matching concept and why they use their particular method to record donations and pledges, thus determining reasons for their actions. Next, the complexities around property, plant and equipment are identified.

3.2.2 Property, Plant and Equipment

Property, plant and equipment (PPE) comprise the buildings and equipment used in a charity’s operation (Accounting Standards Committee, 1984) that the charity will keep for longer than twelve months: it is also known as ‘fixed assets’. The complexities arise, with regards to when it is appropriate to record each PPE and if recorded whether PPEs are depreciated. GAAP will determine when to record and depreciate PPE, which will be looked at next.

3.2.2.1 GAAP

R120 (New Zealand Institute of Chartered Accountants, 1999) states that the initial cost of a fixed asset must be recorded and depreciated (paragraph 5.8). For PPE that are donated, their value should be fair value, but how fair value is ascertained is not detailed. The NFPFRG (New Zealand Institute of Chartered Accountants, 2007a) has similar requirements (paragraph 4.79) but stipulates that the value of PPE should be reviewed regularly to ensure the value has not been impaired (paragraph 4.83), which specifically relates to New Zealand International Accounting Standard (NZ IAS) 36 Impairment (New Zealand Institute of Chartered Accountants, 2006). With regards to donated PPE, as with the R120, the NFPFRG determines valuation at fair value. This is stipulated in NZ IAS 16 paragraph 15.1 (New Zealand Institute of Chartered Accountants, 2004b). NZ IAS 16 paragraph 6 defines fair value as “*the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s*

length transaction”. This definition assumes that there is a recognised market for the particular PPE, which is not always the case (Gillingham & Yeoh, 2007). A lack of guidance is also seen in paragraph 4.125 which states that these assets should be depreciated where appropriate, but does not detail what are appropriate circumstances. This reflects paragraph 43 of IAS 16 which stipulates that each PPE should be separately depreciated (International Accounting Standards Board, 2008c).

In England and Wales the SORP paragraph 253, stipulates that all PPE should be capitalised and, under paragraph 259, all should be depreciated (Charity Commission, 2005). In relation to donated PPE the SORP paragraph 255(c) states that donated assets are required to be recorded at their current value at the date of the gift, with again no elaboration as to how to determine current value.

Neither New Zealand GAAP nor the SORP provide any practical guidance as to how charities can determine ‘fair value’ or ‘current value’. A lack of instruction leads to inconsistencies in the application of these paragraphs, meaning a wide variety of valuation methods are utilised by the charities sector. This study will determine how charities put a figure on ‘fair value’, particularly in relation to PPE that has been donated. Next, studies relating to the PPE and any additional complexities that they highlighted, will be investigated.

3.2.2.2 Studies

International studies have found that there are three principal methods by which charitable organisations value their PPE (Accounting Standards Committee, 1984; Anthony, 1978; Ashford, 1986; Beechy & Zimmerman, 1992; Bird & Morgan-Jones, 1981; Connolly & Hyndman, 2000; Hines & Jones, 1992; Hooper et al., 2008; Institute of Chartered Accountants in Australia, 2006; Mautz, 1989; Newberry, 1992; Rees & Dixon, 1983; Williams & Palmer, 1998):

1. Written off on acquisition; or
2. Capitalised and not depreciated; or
3. Capitalised and depreciated i.e. GAAP.

With regards to whether expenditure on PPE should be capitalised or expensed on acquisition, expensing has the advantage of showing more clearly the cash-flow effects of purchasing PPE. This was supported by Mautz who recommended expensing PPE rather than capitalising (Mautz, 1989). The disadvantage of expensing is that it excludes substantial resources of the charitable organisation from the balance sheet by expensing

the PPE in the acquired year (Accounting Standards Committee, 1984). This means that users would be unable to make an informed opinion on the efficiency and effectiveness of charitable organisations' resources. In England, Bird and Morgan-Jones (1981) found that 20% of charitable organisations wrote their plant and equipment off on acquisition. In New Zealand, Newberry's study (1992) found that 14% of charitable organisations did not capitalise some of their PPE.

The second valuation method, where PPE is capitalised and not depreciated (Accounting Standards Committee, 1984). Bird and Morgan-Jones (1981) found that 6% of charitable organisations recorded their plant and equipment at cost with no subsequent depreciation. In New Zealand, Rees and Dixon's study (1983) found that some organisations did not depreciate PPE. Newberry's study (1992) later supported this by identifying that 16% of those that capitalised did not depreciate. Hines and Jones (1992, p. 63) considered that "*the failure to depreciate [PPE once capitalised] is puzzling*".

The third valuation method, where the PPE is capitalised and depreciated, is the agreed GAAP in R120 and NFPFRG. It is also the agreed GAAP in England and Wales, where various studies were conducted after the strengthening of GAAP through the publication of various Statements of Recommended Practices (SORPs) (Charity Commission, 2005), which saw an improvement in recording and depreciating PPE from: 13% (Bird & Morgan-Jones, 1981); 70% (Hines & Jones, 1992); 88% (Williams & Palmer, 1998) to 99% (Connolly & Hyndman, 2000). These studies relate to large (>GBP650, 000) charities. In relation to medium sized (GBP 100,000-650,000) charities, Connolly & Hyndman (2001) determined that 76% depreciated their PPE.

Two issues arise out of these studies. The first issue relates to the first valuation method i.e. writing off PPE on acquisition particularly donated PPE. An Australian study (Institute of Chartered Accountants in Australia, 2006) found that the majority of respondents that received donated PPE neither recognised them nor explained their accounting treatment.

The second issue arises out of the second and third valuation method and relates to depreciation. There have been numerous arguments both for, and against, depreciation. The argument for depreciation considers that, as PPE wear out, this is a cost which the charity suffers and as the PPE are within the control of the charity they should be recorded and depreciated (Accounting Standards Committee, 1984).

There are four arguments against depreciation. Firstly, as a charity's income is voluntary and in most cases unrelated to its costs, so including a charge for depreciation would not provide useful information about how efficient a charity is in raising and using its income (Accounting Standards Committee, 1984). Secondly, if PPEs are the result of donations, charitable organisations may feel that there is no need to recover the cost from revenues so no depreciation is needed (Hines & Jones, 1992). Third, PPE are being maintained at their 'current condition' so are not depreciating, which follows the concept of prudence, in particular, which is not to overvalue assets, in this case PPEs (Williams & Palmer, 1998). Finally, depreciation can lead to funds being raised twice for the same PPE, e.g. PPE purchased through special appeals and then depreciated are included in the costs on the basis of which subsequent appeals are made (Accounting Standards Committee, 1984).

Anthony (1978, 1989) also considers that PPEs that are donated should not be depreciated. He went so far as to say GAAP was illogical because the depreciation relates to assets and should not affect the measurement of income. His American study found nine different alternatives for depreciation as a result of his interviews with 53 people (Anthony, 1978). He later conducted an American study (Anthony, 1995) of 393 NFPs which found that 44% of them did not depreciate donated PPE. This again supported Rees and Dixon (1983) who found that assets that had been donated, if recorded, were not depreciated as charities considered that, as they had not 'cost' the organisation anything, there was no cost to allocate by way of depreciation. The need to value some donated PPE was highlighted by Beechy and Zimmerman's (1992) research which determined that if organisations would have to pay for the PPE, if it were not donated, then the PPE value should be recognised.

The two issues with PPE firstly relate to the valuation of donated PPE and how fair value is determined, and secondly whether PPE are depreciated and if not, why not. This study will investigate why particular valuation and depreciation methods are used to determine why charities chose their particular treatment of PPE. The complexities which are inherent in fund accounting are considered next.

3.2.3 Fund accounting

Fund accounting has been around for some time and was extensively researched over sixty years ago by Vatter (1947), who first attempted to set up a framework for fund accounting. The most widely recognised definition for fund accounting is that of

Herzlinger & Sherman (1980, p. 95) who defined it as a “*collection of cookie jars in which resources for various purposes are stored*”. The English and Welsh Charity Commission still considers that fund accounting remains a key feature of charity accounting (Charity Commission, 2005). This contrasts with O’Connor who considers that fund accounting has become obsolete elsewhere (O’Connor, 2007). In New Zealand, fund accounting has not become obsolete and Rees and Dixon’s study (1983) identified that 69% of not-for-profits have some form of fund accounting. This was supported by Newberry (1992) who found 62% of charities practise some form of fund accounting. Next, the GAAP, if any, of fund accounting is determined.

3.2.3.1 GAAP

Before going further and looking at the recording of funds there is a need to clarify the terms used in fund accounting. In particular, it is necessary that a distinction be made between funds and reserves. Restricted funds have a restriction imposed by the donor. The NFPFRG (paragraph 4.172) defines restricted reserves, also referred to as provisions, as amounts that have been set aside by the charity, not donors, for future expenses or as a buffer against adverse events (New Zealand Institute of Chartered Accountants, 2007a). Hence, reserves are just arbitrary amounts that the charitable organisation has decided to separate out.

Donors may have placed restrictions or conditions on their donations i.e. funds. A restriction (International Public Sector Accounting Standards Board, 2006) limits or directs the purposes for which the contribution may be used whereas a condition (New Zealand Institute of Chartered Accountants, 1999) stipulates a right of return of the donation if, for example, it is not used. With regards to a definition of restricted funds R120 paragraph 3.35 (New Zealand Institute of Chartered Accountants, 1999) states that funds may be split between restricted and unrestricted. However, there is no indication as to what these terms specifically mean. While the NFPFRG makes no explicit mention of fund accounting, it offers more guidance on accounting for conditions and restrictions of assets. The NFPFRG (paragraph 4.136) utilises the definitions from IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers) to define restrictions (International Public Sector Accounting Standards Board, 2006). However, whilst the NFPFRG has a detailed analysis of eight different types of bequests (paragraphs 5.40-5.49) there is no specific definition given of endowment, even though these are required in charities’ Annual Returns (Charities Commission, 2008c). An exposure draft (Australian Accounting Standards Board &

Financial Accounting Standards Board, 2009) jointly released by Australia and New Zealand, ED118 Income from Non-exchange Transactions (Taxes and Transfers), acknowledges fund accounting and incorporates a specific definition of conditions as well as suggesting when income would be recognised in non-exchange transactions such as donations.

In relation to the reporting of these funds, R120 paragraph 5.25 requires disclosure on the restriction of cash and PPE. Specifically, NZ IAS 7 Statement of Cash Flows, paragraph 49.1 requires that any restrictions on the use of cash must be disclosed. NZ IAS 16 PPE paragraph 74(a) states that any restriction on the title of PPE must be disclosed. However, it does not require disclosure on restrictions on equity. This means that movements between funds may not be clear and it could be hard to look at whether expenditure and income is being correctly allocated to particular funds. The Annual Return question 25 requires equity to be split between: Endowment funds; Restricted purpose funds; and General accumulated funds. The recent exposure of IPSAS 23 requires the disclosure of the amount of restricted assets to be recognised and the nature of those restrictions detailed (Australian Accounting Standards Board & Financial Accounting Standards Board, 2009). Also the breakdown of changes to restricted and unrestricted equity must be shown in the notes to the financial statements.

This contrasts with the SORP paragraph 74, that requires clear separation between restricted and unrestricted funds (Charity Commission, 2005) and that movements on major funds should be shown separately from allocations to designated funds without aggregation, accompanied by a narrative explanation. This led to the adoption of the Statement of Financial Activities (SoFA), as England and Wales considers that the main purpose of the financial statements of charities is to give an overall view of total incoming resources (Palmer & Randall, 2002). The SoFA achieves this by providing a summary of all the charity's funds, i.e. all its incoming resources and resources expended, and transfers between funds. It also separates by means of a columnar format: unrestricted funds; restricted funds and endowment funds (*Appendix One*). Thus it shows what funds the charity has and how they have been used, thereby amalgamating the IASB's Income Statement and Statement of Changes in Equity, but clearly separating unrestricted funds, restricted funds and endowment funds (Palmer & Randall, 2002).

NZ IAS 27 Consolidation and Separate Financial Statements determines which funds to include in the financial report by consideration as to what is the reporting entity (New

Zealand Institute of Chartered Accountants, 2008). The concept of a reporting entity is not currently explicitly prescribed within the conceptual framework. However, the International Accounting Standards Board (IASB) has released a discussion paper (International Accounting Standards Board, 2008d) on what constitutes a reporting entity. Also, with relation to when to include funds in the charities' financial statements, the notion of 'control' is paramount. The IASB (International Accounting Standards Board, 2008d) defines control as including the ability to access the benefits from that entity, e.g. the income from the fund, and maintain or protect the amount of those benefits, e.g. the assets of the fund. In New Zealand the NFPFRG paragraph 2.24 (New Zealand Institute of Chartered Accountants, 2007a) has a similar definition to the IASB. Also SORP paragraph 381 requires consolidated accounts (Charity Commission, 2005).

The complexities in fund accounting arise firstly from the myriad of terminology used, and with no prescribed New Zealand GAAP as to which term to use, leads to a lack of understanding as to what the term 'fund' really means. There is also a complexity behind how funds are recorded, as New Zealand GAAP is not clear how funds should be recorded, although New Zealand GAAP is clear on whether funds should be part of a separate entity or consolidated in relation to the notion of control. However, control is not easily determined in the charities sector and New Zealand GAAP offers no detail on how this assessment should be undertaken. Studies on these complexities will be looked at next to identify whether there is any commonality of terms, in the recording of funds received, and when to consolidate.

3.2.3.2 Studies

The importance of transparency in relation to fund accounting was seen in the New Zealand Charities Commission's 'Trust and Satisfaction Survey' (Charities Commission, 2008e), which found that transparency and information about the destination of funds was the most noted need in the New Zealand charitable sector, nominated by 31% of survey respondents.

Walker (2004) considers that fund accounting is the perennial problem confronting charities as there is a need for a sophisticated understanding of what the different rules are, in relation to each individual fund, before the appropriate recording method can be determined. This is supported by substantial research (Accounting Standards Committee, 1984; Anthony, 1978; Ashford, 1986; Bird & Morgan-Jones, 1981; Blasch et al., 1994; Charity Commission, 2006; Connolly & Hyndman, 2000, 2001; Hooper et

al., 2008; Newberry, 1992; Rees & Dixon, 1983; Vatter, 1947; Williams & Palmer, 1998).

Early English studies highlight the lack of a clear definition of 'fund', with some funds referring to contributions from donors who have placed restrictions on the use of them and other funds referring to unrestricted funds which have been earmarked by management for a particular purpose i.e. reserves (Bird & Morgan-Jones, 1981). William and Palmer (1998) found that many English charities were providing inadequate information about funds. However, the introduction of the SORP, with specific definitions, ensured that for large charities, by 2000, (Connolly & Hyndman, 2000) all of the funds of the charity were clearly labelled, and for medium-sized charities 90% complied (Connolly & Hyndman, 2001).

This has not been resolved in New Zealand, where Rees & Dixon (1983) found that little information was given to indicate what funds were used for and whether they were restricted in any way. This was supported by Hooper, et. al. (2008) who found that there is still a lack of consistency in the titles being used. One charity could use designated funds, which means that the funds are restricted by the donors. Whereas in another charity designated funds are funds that are not restricted by the donors, but are set aside by the charity for a particular purpose i.e. reserves. This is particularly concerning given that Charities' Annual Return (Charities Commission, 2008c) requires equity to be split between: endowment funds, restricted purpose funds and general accumulated funds, with no explanation given as to what this means.

Whilst New Zealand and Australia are undertaking a joint project (Warren, 2007) to try and clarify these definitions to the researcher's knowledge this has not yet occurred. It is important for the transparency of charities' financial statements that an understanding is developed of why charities are using the different terms to determine the most appropriate definitions to use.

In relation to the recording of funds, Bird and Morgan-Jones (1981) found that funds were recorded in three ways: first as capital (29%); second as income (48%); and third with a proportion to the Income Statement and the rest to a suspense account (23%). A later study found that 60% of large charities passed items directly through to reserves (Williams & Palmer, 1998). However, after the publication of the SORP with its stipulation that funds be credited to income, Connolly & Hyndman's (2000) study of

charities in England and Wales found 90% compliance in large charities and their 2001 study found 97% compliance in medium sized charities (Connolly & Hyndman, 2001).

An earlier New Zealand study (Rees & Dixon, 1983) found that movements in charities' funds were difficult to trace. A later study by Newberry (1992) found that 44% of charities failed to disclose transactions of some funds or disclosed movements through funds in a misleading manner. Newberry (1995b) suggested that it would be most helpful to utilise a multi-columnned extended Income Statement. However, New Zealand is still waiting for that suggestion to be implemented and this remains a threat to transparency and understandability.

The Accounting Standards Committee (1984) considered that there were two ways of reporting funds. First, reporting separate accounts for each different fund and second, as per the SoFA, reporting a columnar statement showing total figures, analysed into columns between funds with external restrictions and funds for use at the charity's discretion.

Rees and Dixon (1983) determined that the first method, the operation of separate fund accounts, was common and the proliferation of these accounts and the fragmented manner of their reporting made the charities' financial statements very difficult to follow.

A New Zealand study to determine the usefulness of the Statement of Financial Activities' format to separate out funds produced contradictory results (Sinclair, Hooper, & Lai, 2009). Although 70% of respondents found it useful to separately disclose restricted funds, 65%, although considering it useful, would not change their current structure. Some respondents specifically commented that their current format was adequate and familiar so there was no need to change (Sinclair et al., 2009).

Also in relation to the first method Anthony (1978, 1989) considers that funds should be consolidated, rather than a number of separate financial statements for each fund. Consolidated funds concentrate attention on the charity as a whole (Accounting Standards Committee, 1984). This supports the SORP's recommendation that consolidated accounts should be prepared (Charity Commission, 2005). This was reflected in Connolly and Hyndman's study (2000) which found that consolidated accounts were prepared in 96% of large charities and, of the medium-sized charities surveyed, 61% consolidated subsidiaries (Connolly & Hyndman, 2001).

However, the notion of control is a major issue in charities especially in relation to NZ IAS 27 Consolidated and Separate Financial Statements, where there is an absence of legal instructions of ownership typically found in public benefit entities, including charities (Bradbury & Baskerville, 2008; Controller and Auditor-General, 2009). The need for the concept of control to be further developed so that it can apply more effectively in a NFP (including charities) context was raised by England, Canada, Australian and New Zealand in their report on the application of the IASB framework (Australian Accounting Standards Board et al., 2008). The definition of ‘control’ and the concept of ‘returns’ being inappropriate for NFPs, including charities, were both raised in a submission (Not-for-Profit Sector Advisory Committee, 2009f) that the author was involved in, on IASB ED10 Consolidated Financial Statements (International Accounting Standards Board, 2008a). This is an example of another complexity where some groups have both for-profit and NFP standards, and was highlighted by Simpkins in his review of the Australian accounting standard setting (Simpkins, 2006b).

In New Zealand, NZICA considers that consolidated financial statements provide more relevant information than a suite of individual financial statement for each entity (New Zealand Institute of Chartered Accountants, 2005). Rees and Dixon (1983) found that several organisations prepared separate activity accounts rather than consolidating, which gave a very fragmented picture of the not-for-profit. This was supported by Newberry’s study (1992) which found that 35% of her sample required consolidated accounts and none of these charities consolidated their subsidiaries. An opposing view to disclosing separately is Mautz (1989, p. 66) who considers that all that is needed is an assertion that “*all restrictions on the use of funds received has been scrupulously observed*”. Another opposing view is that of Weinstein (1978) cited in Cordery and Baskerville (2005) who considers that the reduction in transparency found in fund accounting outweighs any benefits of tracking specific legacies. On the other hand, Ashford (1986) presents a rather contradictory view by considering that the consolidation of funds is not desirable, as it results in a reduction in the amount of information in the accounting report. However, he goes on further to say that the use of separate funds “*can make the reading of accounts quite difficult and hard to see an overall picture of the work of a charity*” (Ashford, 1986, p. 23). He unfortunately doesn’t offer a solution to this conundrum.

The key thing is to present the user of the financial statements with a clear indication of the various funds and their movements. The issues revealed by this examination of GAAP and key prior studies are the lack of guidance of how funds should be reported, and limited guidance as to when funds should be consolidated, due to the notions of 'control' and 'returns' not currently being appropriate to charities under the IASB's definition of control. Thus, in this study, it will be important to ascertain which funds charities include in their consolidated financial statements, if applicable, and why they include, or exclude, these different funds, to determine if the notion of control is consistent amongst charities. Next, the issues relating to reporting expenditure overheads ratios will be considered.

3.2.4 Expenditure overheads ratio

A fourth complexity identified by Hui (2006) looks at the reporting of administration and fund raising expenses. The complexity looks at whether donations have been 'properly spent' through analysing the proportion of donations that are not directly spent on beneficiaries but spent on administration and fundraising. This focus on the expenditure overheads ratio is also supported in research by Palmer & Randall (2002) who found that these costs elicit the greatest interest from the general public.

3.2.4.1 GAAP

Fundraising expenditure refers to the costs incurred by a charity in inducing others to make donations to the charity (Charity Commission, 2005). NZICA's R120 paragraph 3.44 (New Zealand Institute of Chartered Accountants, 1999) details that gross fundraising revenues should be separately disclosed and paragraph 8.9 states that fundraising expenses should usually be disclosed. It does not explicitly state which circumstance falls under 'usually'. Also in paragraph 3.44, the net results of fundraising activities may be provided as additional disclosure. The more recent guide NZICA's NFPFRG (New Zealand Institute of Chartered Accountants, 2007a) is more explicit in stating that gross expenses must be disclosed and not be offset with revenue. NFPFRG paragraph 5.23 gives organisations the opportunity to analyse expenses by nature, e.g. salaries, or function, e.g. fundraising. Also, paragraph 5.50 encourages disclosure of direct fundraising costs.

The Charity Commission in England and Wales refer to fundraising expenses as the 'costs of generating funds' and under SORP paragraph 183 these are required to be shown separately in the notes to the financial statements (Chitty & Whitehill, 2007;

Kilcullen et al., 2007b). Charities with income greater than GBP1 million must show, as part of their Annual Return, how much of income was directed to their charitable purpose as opposed to administration and fundraising expenses (Charities Commission, 2009c). From 2008 the SORP focuses on three main activity groups: (1) charitable activities; (2) fundraising activity; (3) governance activities (Charity Commission, 2008e).

The New Zealand Charities Commission has released a 'Hot Topic' bulletin on fundraising costs (Charities Commission, 2009c). They do not prescribe an 'appropriate' maximum percentage of fundraising expenses but highlight several key points, including:

There is no law or rule of thumb about how a charity spends donations that have been given to it. Sometimes 'fundraising' drives are not about getting donations, they are about developing relationships with donors who could give to the charity over a period of years; because charities can show their financial information in a number of different ways a 'ratio' ... may give a very misleading picture of many charities' finances (Charities Commission, 2009c, pp. 1, 3, 5).

This contrasts with the position in Australia (Institute of Chartered Accountants in Australia, 2006) where there is a proposal to show the ratio of total costs of fundraising to gross income obtained from fundraising. Whether this focus on the expenditure overheads ratio is the relevant measure for donors to use when choosing which charity to support, will be considered in this research.

3.2.4.2 Studies

Numerous researchers have found that donors are concerned with how much money is spent on expenditure overheads, e.g. fundraising and administration (Abraham, 2007; Anthony, 1978; Ashford, 1986; Association of Fundraising Professionals, 2009b; Baskerville, 2006; Charity Finance Directors' Group, 2003; Henderson, 2002; Palmer & Randall, 2002; Pro Bono Australia, 2009; Rees & Dixon, 1983; Senate Standing Committee on Economics, 2008). Individual donors want to see their donations used immediately in the provision of the services which are the 'raison d'être' of the charitable organisation. This was highlighted in a question to a newspaper columnist (Holm, 2006) who was asked to provide a list of charities that spent little or no part of their income on overheads. This is a rather unrealistic view, as all charities will have some sort of overheads that need to be covered by donations. However, people working in charities do need to eat, unless you limit involvement to only those people who have independent means – a rather unrealistic thing to do given the current economic climate.

The negative side of transparency comes through here, where donors are using transparency so they can pick and choose who they should support. Donors want low administration costs and low fundraising costs, which is one of the reasons for more transparency. As the Australian Senate report highlights: “*the paradox comes that they [donors] are not willing to pay for the cost of transparency*” (Senate Standing Committee on Economics, 2008, p. 99). In other words donors use transparency to make sure they are not paying for fundraising or administration costs. In fact donors object to paying for these expenses because they believe that the costs have nothing to do with the particular project they are donating towards. As Palmer and Randall correctly highlight: “*This is wrong. All organisations have overhead costs that are real administration costs and must be paid for*” (Palmer & Randall, 2002, p. 176). Administration costs are supporting the disbursement of funds received and provision of service (Hyndman & McKillop, 1999; Senate Standing Committee on Economics, 2008). Bradach, Tierney & Stone (2008, p. 97) go further and consider charities response to this is to:

Both underinvest in infrastructure and underreport what they’ve spent – thereby reinforcing external expectations about what is (and isn’t) appropriate. In the short run, staff members may be able to ‘do more with less’, but ultimately the organisation’s beneficiaries suffer.

Therefore, unless there are donors who are willing to provide the funds that every charitable organisation needs to finance its administration and fund-raising (Bird, 1985), all donors will need to help fund the ‘running costs’ of the charities. Some innovative charities have addressed this problem by clearly advertising the cost of the product they are selling and what precisely goes to the charity, for example tea towels which cost \$4 and retailed for \$10 meaning that 60% of the funds received went to the charity (Anonymous, 2009, 10 September). Also in New Zealand, DineAid had their overheads covered by Mercedes Benz and Kensington Swan meaning that 100% of donations went to charity (Anonymous, 2009, 18 December).

The relationship between funds raised and fund-raising expenditure is regarded as an important indication of the efficiency of a charitable organisation’s fund-raising efforts (Accounting Standards Committee, 1984). An important management problem in any charitable organisation, which relies largely on donations and grants, is to ensure that money is used efficiently, and in particular that overhead costs are not too high. One way of lessening the reluctance of donors to fund overheads is the need to report clearly

the amount of money spent on administration and fund raising costs, so that contributors can see that these are not excessive (Ashford, 1986).

In regards to an agreed 'benchmark', Baskerville (1999) supports this by suggesting that there needs to be an agreed proportion of funds raised that can be used for overheads, e.g. fundraising and administration. She even went so far as considering that one of the ways charities legitimise their activities is through the transparency of the percentage of funds used for fundraising and administration (Baskerville, 2006). This was also supported by Lee (2003) who thought that being able to compare ratios would be a useful benchmark for charities competing for limited resources. This supported Newberry's (1995a) view that high fundraising and administration costs can result in the charity being considered inefficient. This can have a big impact on a charity as can be seen in the USA where Fishman raised the point that:

Attorneys general assume that if a fundraising ratio exceeds 50%, there is a presumption of fraud or private benefit. This is based on a flawed rationale that a high... ratio is improper. This ignores the fact that charities solicitation is also educational and an attempt to introduce potential donors to the organisation (Fishman, 2007, p. 277).

Donors want to determine what portion of their donation should be spent on administration and fundraising expenditure. There is a huge variety in the proportions used including: 75% for the National Child Health Research Foundation Jeans Day (Baskerville, 1999); 15% Oxfam (Bird & Morgan-Jones, 1981); 75% Care Foundation (Henderson, 2002). At the other extreme Compton (2006) considers that no more than 10% should be allocated to administration and fundraising, compared with Ferguson (2006) who considers that between 5-10% is appropriate, both well under the 75% in two of the previous examples. In Canada, the Association of Fundraising Professionals consider that the media has contributed to this focus with sensationalised explanations (Association of Fundraising Professionals, 2009a). Some New Zealand examples of this include KidsCan where 82% of income was spent on overheads and Epilepsy Foundation spending 97.5% of income on overheads. (Editorial, 2009, 16 August; McCracken, 2009, 16 August, 2009, 26 July).

For a benchmark to be successful it is important to ensure that there is similarity between charitable organisations as to what is being included in the administration and fund raising expenses. Bird and Morgan-Jones' study (1981) found that some charities deduct fund raising costs from the relevant income, and others show a breakdown of both types of expense, while others do not (Bird & Morgan-Jones, 1981). As the

prescriptive nature of the SORP (Charity Commission, 2005) came into effect further English studies found that fund raising, publicity and administration expenses were separately disclosed for large charities from 30% in 1992 (Hines & Jones, 1992) to 71% (Connolly & Hyndman, 2000). Further research on medium-sized charities found 98% of English charities complied with the SORP (Connolly & Hyndman, 2001). However, New Zealand (New Zealand Institute of Chartered Accountants, 2007a) just requires expenses to be disclosed either by nature, e.g. rent, or function, e.g. fundraising (paragraph 5.23), so it can be impossible for a donor to determine what proportion of expenses are fundraising or administration, if the expenses are shown by their nature, rather than their function.

However, the acceptable maximum percentage of charitable income that should be spent on raising further donations can depend on the nature and size of the charitable organisation (Association of Fundraising Professionals, 2009b). For example, a charitable organisation “*may properly spend all of its income on administration if its function is to organise the rendering of charitable services entirely by unpaid volunteers; another organisation may operate by making grants to other agencies and could reasonably be expected to restrict its administrative expenses to a very low percentage of its total income*” (Bird, 1985, p. 163). Also fundraising costs vary according to the life cycle of the charity, e.g. a new charity will have considerably greater expenses than a well established charity (Senate Standing Committee on Economics, 2008).

As with New Zealand, England and Wales have seen an increasing amount of press attention directed towards fundraising and administration costs and this has led to a demand for suitable bases for comparison between competing charitable organisations (Lee, 2003). From this discussion arose a project to develop a more appropriate benchmarking methodology for fundraising performance (Lee, 2003). This project will involve two steps: first, an annual study of fundraising cost ratios and second a study of the specific forms of fundraising (Lee, 2003). Molloy (2006) had the contrary view that emphasis should not be placed on expenditure but rather on the quality of services delivered to the beneficiaries for each NZD1 donated, i.e. focusing on the benefit. For as Lammers says in Breen (2009, p. 119):

choosing which charity to support based only on financial ratios is a little like choosing a restaurant based on how much it spends on advertising and marketing versus food (Lammers, 2003, p. 1).

This research seeks to identify what the prevailing view is about reporting separately the expenditure overheads ratio, and whether emphasis should be placed on the ‘value given’ to beneficiaries rather than expenditure overhead ratios. If emphasis should not be placed on the expenditure overheads ratio, this research will consider how charities are reporting to their stakeholders.

3.3 Summary

A review of the literature has identified significant gaps where little is known, or there appears to be a lack of research, on the complexities in charities’ financial statements. Whilst there is substantial research as to how charities show certain items, there is a lack of understanding as to *why* charities show things a particular way.

The significant gaps that this research endeavours to close are four-fold. First, it is seeking to understand the reasoning behind the accounting basis charities are choosing, i.e. modified accrual accounting, accrual accounting, or cash accounting, particularly in relation to pledges. Secondly, this research will consider charities’ views on the recording of PPE and the reasons for choosing the recording method, and whether that complies with the conceptual framework, including the need to depreciate PPE. Third, the research will clarify meaning behind common terms used in fund accounting and whether it is important to split funds between restricted and unrestricted. One key issue for fund accounting is whether to include, or exclude, different funds, i.e. consolidation and why charities choose to act as they do. Finally, this research seeks to identify what the prevailing view is about reporting separately the expenditure overheads ratio, or whether emphasis should be placed on the ‘value given’ to beneficiaries and whether this would be useful to the users of charities’ financial statements.

These gaps in understanding on these complexities are important to resolve in order to improve the transparency and understandability of the financial statements of charities, and live up to the Government’s expectation that making the financial statements of charities publicly available will increase the confidence by donors over which charities to choose for their donations.

The next chapter will address the methodology and methods undertaken to investigate the complexities identified in this chapter.

CHAPTER 4: RESEARCH METHODOLOGY & METHOD

4.1 Introduction

The literature reviewed in *Chapter Two* explained how the regulatory and conceptual framework operated in: Australia; England and Wales; and New Zealand. *Chapter Three* focused on the conceptual framework in England and Wales, and New Zealand and identified four complexities in charities' financial statements that were then analysed in terms of the appropriate GAAP and what relevant studies, if any, had been undertaken. The focus of these prior studies was on what accounting methods charities used rather than why they used this method, which is the focus of this research.

This chapter outlines the research design of this study. The design of this study was adapted from that proposed by Munck (1998). The first step was to formulate the research question (*section 4.2*) by identifying significant gaps within the charity literature, as developed in *Chapter Two* and *Chapter Three*. Next, the paradigm that shapes the data analysis, i.e. the methodology, was considered (*section 4.3*). Third, the data collection for this study was considered including: documents reviewed in this study were identified (*section 4.4*); and semi-structured interviews, information conversations and follow-ups (*section 4.5*). After the collection of the data, then the data needs analysing (*section 4.6*). Within analysis there are issues in the trustworthiness of the data collection, as well as the data analysis, that need to be considered and these are covered in the evaluation of the data (*section 4.7*). Also any ethical implications (*section 4.8*) were evaluated before finally the theory that shapes the research findings in this research, accountability, is considered in the next chapter. Before looking at the methodology that this research will use, the research question is discussed.

4.2 Research Problem

The aim of this study is to look at the complexities relating to transparency and understandability in the financial statements of organisations that exist to carry out a charitable purpose. This study was influenced by the unveiling of the financial information of registered charities through their Annual Return, to which their financial statements must be attached. These are publicly available through <http://www.register.charities.govt.nz/CharitiesRegister/>.

The key research question for the current study is “*What are the complexities, in terms of transparency and understandability, with the financial statements of charities?*”

As a result of the literature review (*Chapter Two and Chapter Three*) the research will focus on the responses of participants in four areas:

1. ACCOUNTING BASIS

- a) Which accounting basis was used in the preparation of the charities' financial statements?
- b) Why do charities use this basis?
- c) How do charities account for donations, especially pledges?

2. PROPERTY, PLANT AND EQUIPMENT (PPE)

- a) How do charities record PPE in their financial statements?
- b) How do charities value donated PPE?
- c) Why do charities do this?
- d) Do charities depreciate their PPE? If so how?

3. FUND ACCOUNTING

- a) Do charities have any funds or reserves? Yes / No
- b) If Yes: What are the funds or reserves for?
- c) Do charities distinguish between funds that are restricted, i.e. funds must be used for a specific purpose, or unrestricted? Why?
- d) Where do charities show funds and reserves on the financial statements?
- e) Why do charities show them like that?

4. REPORTING TO STAKEHOLDERS

- a) Do charities record the expenditure overheads ratio separately in the financial statements? Yes / No
- b) If yes: Why do charities chose to separately record the ratio?
- c) If no: Do charities separately record administration and fund raising expenses so that expenditure overheads ratios can be calculated?
- d) If yes: Why do charities separate the expenditure?
- e) If no: Why do charities not separate out the expenditure?
- f) If charities are not reporting their expenditure overheads ratio how are charities reporting to their stakeholders?

In considering the above questions, the multiple realities revealed through the experiences of the interviewees included in this study establish a firm theoretical basis for further research in this area and guide the development of practice aimed at improving the readability of charities' financial statements through ensuring their

statements are transparent and understandable to their users. The rationale for the research methodology is discussed next.

4.3 Methodological approach

The methodological approach of any research influences the basis upon which data is collected, analysed and evaluated. The following section discusses the naturalistic inquiry approach to research, and its appropriateness as the methodological framework for the present research.

The present study is a qualitative inquiry into the accounting methods charities in New Zealand use with regards to: determining the accounting basis; recording property, plant and equipment; recording funds; and accounting for the expenditure overheads ratio. The qualitative inquiry seeks to gain a deeper understanding of the research moving from what accounting methods charities use to *why* charities use those methods (Hill & McGowan, 1999). Of particular relevance to this study is the naturalistic paradigm, which is in line with the aim of this study to understand reasons charities act as they do in their natural setting in order to present reality as it is (Grimwood & Tomkins, 1986).

Lincoln and Guba (1985) consider that there are five basic beliefs, or axioms with naturalistic inquiry. *Table 4-1* gives an overview of these five axioms relating to a naturalistic paradigm after which an analysis of the meaning of each axiom and its relevance for this research will be analysed to support the naturalistic inquiry approach followed in this research.

	<i>Axioms</i>	<i>Naturalist Paradigm</i>
1	The nature of reality (ontology)	Realities are multiple, constructed, and holistic.
2	The relationship of knower to known (epistemology)	Knower and known are interactive and inseparable.
3	The possibility of generalisation	Only time- and context-bound idiographic statements are possible.
4	The possibility of causal linkages	All entities are in a state of mutual simultaneous shaping, so that it is impossible to distinguish causes from effects.
5	The role of values in inquiry (axiology)	Inquiry is value-bound.

Table 4-1 Naturalistic Axioms (Lincoln & Guba, 1985, p. 37)

4.3.1 Axiom 1 - The nature of reality

Ontology is a branch of philosophy concerned with the nature of 'being'. Scapens & Yang consider (2008) that ontology has two aspects. First, the 'modes of existence', i.e.

the elements of the world, or rather what exists, and secondly, the ‘nature of their existence’.

Existence is at the heart of the nature of ‘being’, i.e. reality. The naturalistic view is that there are multiple realities: this contrasts with the positivist view who consider that there is only one reality (Lincoln & Guba, 1985, p. 37). Lincoln & Guba (1985, p. 82) also felt that philosophers would consider ‘reality’ at any one of four levels: (1) objective; (2) perceived; (3) constructed; and (4) created.

This essence of multiple realities is at the heart of this research, where the charities sector has many facets or realities existing within it, i.e. different individual experiences and beliefs. Objective or hypothetical reality considers that there is one tangible reality (Lincoln & Guba, 1985). The diversity in charities for similar causes suggests that there is diversity throughout the charities sector, meaning that a single reality appears unlikely and that objective reality is not a good fit for this study.

Perceived reality considers that there is a reality that one cannot fully determine but can be appreciated from particular vantage points, which can be called perceptions (Lincoln & Guba, 1985). Lincoln & Guba (1985, p. 83) defined a perception as “*a partial, incomplete view of something that is nevertheless real and capable of different interpretation when seen from different viewpoints*”. This appears relevant for this research, with the charities sector so complex and diverse that people cannot know all of reality at any point in time but an individual could consider a partial picture, i.e. perception, of this reality.

Constructed reality and created reality question whether reality really exists (Prescott, 2009). These realities deny that individuals have a belief system which sits outside the charities sector. This is contrary to the reason for many people’s involvement in charities is because of their belief system which sits outside of the charities sector, e.g. their religious belief or other altruistic beliefs (Andreoni, 1990). Thus, these are not applicable to this research.

4.3.2 Axiom 2 - The relationship of knower to known

Axiom 2 considers that the knower and the known are both interactive and inseparable as opposed to the positivist’s belief in independence between the knower and known (Lincoln & Guba, 1985, p. 37).

Relationships and relationship building are both core aspects of the charities sector, so much so that many interviewees made the point of saying to the researcher that they were only doing this because the researcher is seen as an ‘insider’, through a prior relationship or the researcher’s work within the sector. As will be highlighted in *section 4.5.1* the researcher needs to have a profile within the charities sector to be seen as ‘part’ of the sector in order to gain the trust of prospective interviewees. Thus, the researcher is seen as part of the sector and having an indirect relationship with the interviewee, rather than maintaining independence. Being seen as an ‘outsider’ limits the responsiveness of interviewees. Thus, the advantages of the research being carried out by an ‘insider’ enabled a greater appreciation of the significance of the interviewee’s stories and experiences (Hill & McGowan, 1999; Prescott, 2009).

4.3.3 Axiom 3 - The possibility of generalisation

Generalisability (Lillis, 2006), is the extent that the findings from research can be generalised to other settings (Lincoln & Guba, 1985; Maxwell, 1992; Ryan, Scapens & Theobald, 1992; Robson, 1993; Patton, 2002; Ghauri & Gronhaug, 2005). Lincoln & Guba (1985, p. 110) consider that the aim of research is to develop assertions that are ‘context-free’.

Consistent with the naturalistic paradigm this research does not aim to contribute findings (*Chapters Six, Seven and Eight*) that claim statistical generalisability but rather theoretical or naturalistic generalisations. The theoretical generalisation is the premise that the findings will generalise back to a theory, in this case accountability (Robson, 1993). The naturalistic generalisations are bound by the context in which the original experiences occur and thus increase understanding of the New Zealand charities sector.

4.3.4 Axiom 4 - The possibility of causal linkages

In the naturalist paradigm organisations are shaped ‘mutually simultaneously’ i.e. it is impossible to distinguish causes from effects or rather “*everything influences everything else*” (Lincoln & Guba, 1985, p. 151). Effects are the conditions to be changed, and causes can be the interventions that will produce more desired effects (Lincoln & Guba, 1985).

In this research the possibility of causal linkages was seen in the relationships between: this researcher; the research participants; the Ministry of Economic Development; Accounting Standards Review Board; and NZICA’s Not-for-Profit Sector Advisory Committee. The changes in the MED and ASRB proposals could be argued to have

come about through the mutually simultaneous shaping of the causal links between the above groups and the resultant effects to the Financial Reporting Act, in relation to private not-for-profit organisations (Accounting Standards Review Board, 2009; Ministry of Economic Development, 2009d).

4.3.5 Axiom 5 - The role of values in inquiry

Lincoln & Guba (1985) consider that values could encompass: axioms; theories; perspectives; social/cultural norms; and personal or individual norms. Values, especially those of the researcher, are an integral part of a naturalistic inquiry. The real issue is whether the researcher takes account of their own value system (Lincoln & Guba, 1985).

In this research close attention was given to my values to ensure that they were exposed, especially in relation to the choice of theory for this research into accountability, and the values inherent in it. Accountability is the theory used to frame the analysis of the findings in *Chapters Six, Seven and Eight*. The value implications of accountability theory are consistent with the researcher's previous work as an auditor, in particular the need for responsibility to be taken for each action within the financial reporting process so that accounts are perceived to be true and fair.

The naturalistic enquiry paradigm generally calls for qualitative research methods as opposed to quantitative methods (Lincoln & Guba, 1985). This was supported by Patton (2002) who feels that qualitative designs are naturalistic to the extent that the research takes place in real-world settings and the researcher does not attempt to manipulate the phenomenon of interests. Further to this Berry and Otley (2004) feel that the connectedness of the qualitative phenomena is an important aspect of the naturalistic paradigm. Thus qualitative data collection methods, both secondary i.e. document review, and primary i.e. interviews, were used in this research, these will be discussed next.

4.4 Document review

The current study is intended to explore the reasons why charities utilise the particular accounting methods in four areas: the choice of accounting basis; the recording of property, plant and equipment; the recording of funds; and the analysing of expenditure overheads ratio. To put these methods into context, a review of documents that impacted on these choices, including appropriate GAAP and the charities sector as a

whole, was required. These were critically reviewed and analysed to consider their effectiveness in informing and shaping the choice of accounting method by participants in the study, or their impact on the environment charities were operating on.

These documents came from a variety of sources including:

- Relevant legislation and case law;
- Charities Regulatory bodies i.e. the England and Wales Charity Commission and the New Zealand Charities Commission;
- New Zealand Government agencies including: the New Zealand Office for the Community & Voluntary Sector; Department of Internal Affairs; Companies Office; Inland Revenue Department; Ministry of Economic Development; State Services Commission; Statistics New Zealand and the office of Simon Power – Minister of Commerce;
- Australian Government agencies including: Australian Bureau of Statistics; Australian Taxation Office; Australian Financial Reporting Council and the office of Ursula Stephens - Parliamentary Secretary for the Voluntary Sector;
- Accounting promulgations from: New Zealand's Accounting Standards Review Board, Financial Reporting Standards Board and NZICA's Not-for-profit Sector advisory committee; the Australian Accounting Standards Board; the English Accounting Standards Board and; the American Financial Accounting Standards Board;
- International promulgations from: International Accounting Standards Board; International Federation of Accountants; International Public Sector Accounting Standards Board;

Also previous research came from a variety of sources including:

- Research reports from charities regulators: the Charities Commission; and the Charity Commission;
- Research reports from accounting bodies including: NZICA, CPA Australia; the Institute of Chartered Accountants of Australia; the Institute of Chartered Accountants of England and Wales and the English Association of Chartered Certified Accountants;
- Research reports from accounting firms including those from: BDP International; Grant Thornton; Hayes Knight; KPMG and PWC;

- Research reports from other organisations including those from: the Centre for Voluntary Action Studies at the University of Ulster; The Australian Centre for Philanthropy and Nonprofit Studies at Queensland University of Technology; Governance, Performance Measurement and Accounting in Not-for-profit-Organisations at Queen’s University Belfast; and Johns Hopkins Center for Civil Society Studies.

Secondary documents such as media reports from newspapers, television, radio and webinars were also reviewed as they provided some of the current context for the research.

Due to the overwhelming number of documents there was a need to develop a process to assess the relevancy of these documents to the research question. This was achieved by allocating a ‘grade’ (*Table 4-2*) on the documents that initially split the documents between those that were essential to include in the thesis, and those that have no relevance to this study. If relevant to the study the document was then evaluated in terms of how essential it was to be included in the thesis, especially if it directly shaped some of the accounting methods.

Grade	Documents
A	Documents that <i>must</i> be included: E.g. research paper on charities and regulatory documents, e.g. SORP, that shapes the findings.
B	Documents that <i>should</i> be included: E.g. source document e.g. MED that should be used as reference.
C	Documents that <i>may</i> be included: E.g. research report that supports the research question.
D	Documents from charities not relevant at the moment to PhD topic
N/A	Of no relevance to the research

Table 4-2 Document review grades

Other documents, which were reviewed before approaching participants as part of the interview process, related to whether the participants were linked to a specific charitable organisation(s). If they were, a search of the charity’s details was undertaken on the four registers i.e. charities; incorporated societies; charitable trusts and company. Also, if the financial statements were available, these were reviewed in terms of the four accounting methods which are the focus of this study. Following is a discussion justifying the interview process engaged in this research.

4.5 Interviews

Previous studies on the financial statements of charities utilised questionnaires (Bird, 1985; Bird & Morgan-Jones, 1981; Blasch et al., 1994; Connolly & Hyndman, 2001; Hyndman, 1990, 1991; Newberry, 1992; Palmer, 1997; Rees & Dixon, 1983) or analysed the financial statements of charities (Charity Commission, 2004; Connolly & Hyndman, 2000, 2004; Hines & Jones, 1992; Palmer et al., 2001; Williams & Palmer, 1998). This research aims to go beyond previous research by not only looking at what actual transactions have been recorded but also why the preparer of the financial statements chose that particular method. Connolly and Hyndman (2000, 2003, 2004) considered that interviews would provide useful insights to explain the reasons for the GAAP used.

Interviews were chosen for the collection of this data as they are the appropriate data collection tool for qualitative researchers (Taylor & Bogdan, 1998). Of particular interest for this study was where the people being interviewed were informants towards learning about activities, such as the reason for particular accounting treatments, that could not be observed directly (Taylor & Bogdan, 1998). An advantage of interviews was that a more accurate and clearer picture of an interviewee's position could be obtained. This was because participants were free to answer according to their own thinking, rather than being constrained in a questionnaire that offered only a few alternatives to choose from (Ghuri & Gronhaug, 2005). Interviews can be categorised into different types including; unstructured interview, informal conversational interview, interview guide approach, semi-structured interviews and the open-ended interview (Ghuri & Gronhaug, 2005; Moll, Major, & Hoque, 2006; Patton, 2002; Robson, 1993; Sekaran, 2003). This study used two types of interviews; semi-structured and informal conversational. Also further informal conversations were held with interviewees, which this study refers to as follow-up interviews.

The formal interviews for this study were semi-structured interviews, as the topics to be covered had been identified through the literature review, in *Chapter Two and Chapter Three* (Ghuri & Gronhaug, 2005; Robson, 1993), unlike an unstructured interview where issues have yet to be identified (Sekaran, 2003). These interviews were guided by key framing questions (*Appendix Three*) relating to these topics (Sekaran, 2003). An advantage of semi-structured interviews was that there was consistency in the questions that each interviewee was asked, ensuring comparability of responses, which facilitated the analysis of the data (Patton, 2002). Another advantage was that a more accurate and

clearer picture of the interviewee's behaviour could be gleaned, as open-ended questions were asked to further develop a particular aspect of the reason for their answer (Ghuri & Gronhaug, 2005; Robson, 1993).

Patton (2002) highlights a possible weakness in this approach in that the standardised wording of questions can constrain and limit the naturalness of the questions and answers. However, as mentioned previously, the negative of this is out-weighed by the plus of having consistency in the questions asked. The use of technical accounting terminology was tailored depending on whether the interviewee had any accounting training. The lack of terminology made several interviewees feel more comfortable and stopped them apologising for 'not being an accountant'.

Interviews can also be very time consuming (Robson, 1993), however for this research the cost of the time was compensated by the wealth of data gathered. Another disadvantage can be the accessibility of respondents and this will be discussed in the next section. Sekaran (2003) considers another disadvantage is when respondents are interviewed when they are extremely busy or not in good humour. This impact was lessened by ensuring that contact was always initially made through email. The researcher found that initially telephoning potential interviewees had a negative impact, as they answered the telephone at an inconvenient time and thus are usually unwilling to participate in the research.

As well as twenty-two semi-structured interviews, informal conversational interviews were utilised in this research. Informal conversational interviews are where questions emerge from the immediate context and are asked in the natural course of a conversation (Patton, 2002). This was particularly important for collecting data from informants in an informal way such as during the networking sessions of NZICA's Auckland Not-for-profit Special Interest group meetings. This was extensively utilised in this study as several participants preferred to talk informally rather than having a set interview time, which led to the ability to collect data from a wider range of informants. Unfortunately, a limitation of these types of interviews, or conversations, is that they can be less comprehensive than semi-structured ones, so that data organisation can be quite difficult, as informal conversational interviews are not guided by the framing questions as semi-structured interviews are (Patton, 2002). However, this negative was again compensated by the wealth of data gathered from these informal conversational interviews, of which seventeen were held.

There were also thirty-six follow-up interviews held, where aspects of the interview were clarified or additional information given by the interviewee that added depth to the data collected. Next the different aspects that need to be considered with regards to interviews will be covered, i.e. preplanning, conducting and recording interviews.

4.5.1 Preplanning the Interview

The first steps in preparing for an interview were to see who would be able to give the data that was required, then there was a need to determine how to select, or rather sample, these prospective interviewees, which is discussed next (Ghauri & Gronhaug, 2005).

INTERVIEW PARTICIPANTS

For this research participants were: (1) people involved in the preparation or auditing of the financial accounts of charities; (2) managers of charities; (3) board members of charities; and (4) experts in charities. Experts included heads of supporting organisations within the not-for-profit sector in New Zealand. In order that as wide a view as possible was taken, interviews took place from September 2008 to February 2010. The research consists of seventy-five interviews comprising: twenty-two semi-structured interviews; seventeen informal conversations; and thirty-six follow-ups (*Table 4-3*).

<i>Type of Interview</i>	<i>Initial interview</i>	<i>Follow-up</i>	<i>Totals</i>
Semi-structured interviews	22	23	45
Informal conversation interviews	17	13	30
<i>Total Interviews</i>	39	36	75

Table 4-3 Number of interviews

Persons involved in small charities were excluded unless they were linked to one of the umbrella bodies within the New Zealand charitable sector and thus considered an expert due to their wider experience and knowledge. There were two reasons for excluding small charities from this research. First, small charities are likely to have less complex operations than larger ones which means that complex International Financial Reporting Standard accounting rules are not necessary (Accounting Standards Committee, 1984), and their rudimentary accounts would not allow the depth of discussion needed for this research. Second, small charities usually have fewer resources and preparing detailed accounts would be an unfair imposition on treasurers and auditors, most of whom are honorary (Accounting Standards Committee, 1984).

In England, Palmer and Randall (2002) considered that a small charity was one which, due to its size, did not have to prepare GAAP-compliant financial statements. At the start of this study the New Zealand Ministry of Economic Development had proposed criteria for small as those charities with income less than NZD100,000, as per *Table 4-4* (Ministry of Economic Development, 2004), which was the measurement used in this study. Near the end of this research the Ministry of Economic Development and the Accounting Standard Review Board proposed different criteria that were referred to in *Table 2-1* (Accounting Standards Review Board, 2007a; Ministry of Economic Development, 2009d).

	<i>Income</i>	<i>Possible reporting requirements</i>	<i>Audit requirements</i>
<i>Small</i>	Less than NZD100,000	Receipts and payments	None
<i>Medium</i>	From NZD100,000 to NZD2,500,000	Accrual accounting	Independent review
<i>Large</i>	Greater than NZD2,500,000	Requirements based on IFRS	Full audit

Table 4-4 Criteria for Small, Medium and Large Charities (MED, 2004, p. 40)

The role of the participants is detailed in *Table 4-5* below. A total of eighty-four participants were involved in this research, thirty-five individually and forty-nine as members of groups. Several participants wore ‘multiple hats’, for example, they may be the treasurer for one charity, a board member for another charity, as well as being a chartered accountant. Thus a total of one hundred and eighteen ‘roles’ were involved. The number or type of charitable organisations involved in this research was unable to be quantified as some interviewees had links to several hundred charities, especially accountants and auditors, whilst other interviewees only had links to one charity.

	Managers	Treasurers	Board Members	Experts	NZICA Members
New Zealand	31	12	25	25	25

Table 4-5 Role of participants

SAMPLING METHODS

There are two major potential sampling methods: probability and non-probability sampling. Probability sampling is when the participants have a known chance, or probability, of being selected as sample subjects (Sekaran, 2003). Non-probability sampling is where the participants do not have any probability of being chosen

(Sekaran, 2003). One type of non-probability sampling is purposive sampling where information is obtained from specific target groups as opposed to convenience sampling where participants are more readily, or conveniently, available.

In qualitative research the purpose is seldom to arrive at statistically valid conclusions from probability sampling of the population (Ghauri & Gronhaug, 2005). Rather it is to understand, gain insights and create explanations. Patton (2002) considered that qualitative research usually focuses in depth on small samples selected purposefully i.e. purposive sampling. Purposive sampling has certain particular characteristics (Lincoln & Guba, 1985). First, there is no prior specification of what the sample size is. Second, there is a serial selection of participants as maximum variation is best achieved by selecting each participant only after the previous participant has been interviewed. Third, as insights and information accumulate the researcher begins to develop working hypotheses and the sample may be adjusted to focus more on those participants that seem most relevant. However, in some cases the research will focus less on particular areas. This happened in this research where there were an overwhelming number of offers received from potential interviewees connected to a variety of 'faith-based' organisations. Consideration was given to adding more interviewees from 'faith-based' organisations, but the decision was made that this would bias the results, so regretfully the offers were declined.

Patton (2002) identifies many different types of purposeful sampling including: (1) extreme or deviant case sampling, (2) intensity sampling, (3) heterogeneity sampling, (4) homogeneous sampling, (5) snowball or chain sampling, (6) criterion sampling. For the purposes of this research, sampling was via a 'snowballing' approach, i.e. getting to know some participants and having them introduce you to others (Taylor & Bogdan, 1998). In this research, to ensure quality, the key to snowballing was to locate information-rich key informants and ask them to recommend people for you to interview. However, one of the potential drawbacks of the snowball technique was that it can limit the diversity of informants. To lessen this potential drawback, participants were also recruited via direct approaches (Taylor & Bogdan, 1998) through the attendance at relevant meetings and courses of organisations such as the New Zealand Institute of Chartered Accountants, the New Zealand Charities Commission and Community and Voluntary Sector Research forums.

APPROACHING PARTICIPANTS

Within the charities sector, finding persons who were willing to be interviewed proved quite difficult, as the charities sector lends itself to personal introductions, i.e. soft doors, rather than a commercial ‘cold-calling’ for interviews. As one interviewee put it:

It's the soft doors that make the [charities] sector work actually, it's how you find a soft door into any sort of organisation.

Thus there was a need to create a profile in the charities sector by developing networks. Networks were developed from: the Community and Voluntary Sector Research forums run by Association of Non-Governmental Organisations of Aotearoa (ANGOA) in Auckland and Wellington; attendance at the 9th Biennial Australia and New Zealand Third Sector Research (ANZTSR) conference; and membership of NZICA's Not-for-Profit Sector Advisory Committee (NFPSAC) which facilitated links to umbrella organisations in the charities sector such as, Philanthropy New Zealand, Fundraising Institute of New Zealand, Volunteering New Zealand, New Zealand Council of Social Services and Federation of Voluntary Welfare Organisation. Preparing submissions on policy issues within the charities sector also increased the profile of the researcher in the charities sector. Submissions were made either individually or as part of NZICA's NFPSAC and included submissions to the Accounting Standard Review Board, Ministry of Economic Development, Inland Revenue Department, Charities Commission and NZICA's Financial Reporting Standards Board (Cordery & Sinclair, 2010a, 2010b; Not-for-Profit Sector Advisory Committee, 2009a, 2009b, 2009d, 2009e, 2009f, 2009g, 2009h; Sinclair, 2006, 2007a, 2007b). Building relationships and then agreeing on an interview time and place took time and resulted in interviews over a long period of time, i.e. September 2008 to February 2010.

In this research, if there had been no face-to-face discussion with the potential interviewee about the research, an email was initially sent to them explaining the purpose of the research and describing the type of information that the research was concerned with, by utilising the Participation Information Sheet (*Appendix Five*). In this email the interviewee was asked if they were willing to be part of this research and be interviewed for a period of not more than one hour (Ghuri & Gronhaug, 2005). As well as attaching the participation information sheet the informed consent form (*Appendix Four*) was attached, but only two interviewees completed them ahead of time, which meant that these were completed at the interview (*section 4.5.2*). If the interviewee's contact details were provided by a previous interviewee, through snowballing, the email

clearly explained who had given the researcher their contact details, thus incorporating that personal introduction, i.e. soft door. If the researcher had met the prospective interviewee before, an additional paragraph was added in the email reminding the interviewee of the previous meeting. Through this way the researcher was able to gather interviewees while not forgetting Ahrens' comment that the negotiation of access for interviews requires subtlety and luck (Ahrens, 2004).

Where the prospective interviewee had links to a specific organisation a search of the three registers i.e. Charities Register, charitable trust register and incorporated society register, was undertaken to ensure that the organisation met the definition of charitable purpose.

If the charity was registered, a search was also conducted in the Charities Register of the interviewee's name to see if they had any other connection to charities, as in this study many interviewees had many other responsibilities. If the interviewee had worked for a particular charitable organisation, chartered accounting firm or an umbrella organisation, their profile on the website was looked at to ascertain not only what the interviewee's specific role was but again to determine if the organisation's purpose was charitable.

As well as searching details to prove charitable purpose, a search for the financial statements of charities the interviewees were involved in was conducted by searching either: the Charities Register's Annual Return for that organisation; the Incorporated Societies' register, which was supposed to have financial statements attached; and finally, if the organisation had a website, a search of the website was done to determine if they had attached their financial statements.

If financial statements were available they were looked at for three reasons. First, it was to determine if the charity's activities were of a charitable nature, second to see if the charity's income was above NZD100,000 (Refer *Table 4.4.*) and thirdly, to determine the accounting treatment for the four identified issues.

Where the financial statements were not available and interviewees were not willing to provide them, mainly in the case of faith-based organisations, I had to trust the interviewee as to whether their charity was of sufficient size to be included in this research. Unfortunately, many registered charities had yet to submit their first Annual Return and thus there was no access to their financial statements. This lack of

availability of charities' financial statements will be resolved, in the case of registered charities, once every registered charity has filed their first Annual Return, unless the charity is granted an exemption, by the Charities Commission, to making their Annual Return publicly available (Charities Commission, 2007a).

SATURATION

The last aspect to consider, before conducting the interview, was how many participants this research should have. Unfortunately, in qualitative research there are no guidelines to estimate the sample size and whether the size is adequate (Morse, 1995). To determine how many participants are required in qualitative research, Lincoln and Guba (1985) suggested that sampling would continue to the point of 'information redundancy', i.e. when no more new information is elicited from the interviewees. This was supported by Morse (1995) who terms the phrase 'saturation' or 'data adequacy', i.e. the point at which no new information is obtained from interviewees. The signals of saturation are where patterns or themes in the data begin to make sense, i.e. the researcher has enough data to build comprehensive and convincing findings (Denzin & Lincoln, 2005). Therefore, the aim is to achieve a qualitative informational isomorph (Lincoln & Guba, 1985; Marginson, 2004). For this research saturation was reached after thirty-nine semi-structured and informal conversation interviews and thirty follow-ups, as the interviewees imparted no further new information, i.e. information redundancy, so that nothing new was learnt from the interviewee. Next, the aspects that need to be considered when conducting an interview are covered.

4.5.2 Conducting Interviews

In conducting a research interview there are some protocols to be considered to ensure the interview runs smoothly, i.e. all possible information is obtained and the interviewee feels comfortable (Taylor & Bogdan, 1998).

At the start of an interview it is important to create an atmosphere where interviewees feel comfortable talking openly and also to ensure that understandable language is used (Ghauri & Gronhaug, 2005; Moll et al., 2006; Taylor & Bogdan, 1998). In this research, one disadvantage of this was that interviewees felt so comfortable that they talked at length about things outside the scope of this research. However, it was important not to antagonise the person by abruptly getting back to the interview topics, and putting an end to the interview was handled with care (Taylor & Bogdan, 1998). Having the interviewee feel comfortable meant that they were more willing to answer

questions freely which reduced the risk of response bias, where the interviewee just answers what they think the researcher wants to know (Bedard & Gendron, 2004). In this research it was useful to use a set of open-ended descriptive questions prior to the interview, which was not related to potentially sensitive issues, as this acted as a conversation starter, which helped towards creating a non-threatening atmosphere (Bedard & Gendron, 2004; Taylor & Bogdan, 1998).

At this stage in the interview the informed consent form (*Appendix Four*) was completed. In this research this was used to start the 'proper' interview, as it acted as an opening to the research topic and, by signing it, ensured that the interviewee was still happy for their interview to be included in this research (Bedard & Gendron, 2004). As well as the informed consent form, the participant information sheet (*Appendix Five*), which had been attached to the initial email, was used to describe the broad objective of this research. It also highlighted the interviewee's right to refuse to answer any questions. If the interviewee was happy to sign they were then asked permission to tape the interview (Bedard & Gendron, 2004).

ESTABLISHING CREDIBILITY

An important aspect of conducting interviews is a need to ensure that the interviews are free from bias. Bias refers to errors or inaccuracies in the data collected. Sekaran (2003) considered that bias can result if proper trust and rapport are not established with the interviewee, or responses are misinterpreted or distorted or when certain types of responses are unintentionally encouraged or discouraged through gestures and facial expressions. An awareness of these issues in this research led to a conscious effort being made to 'school' one's facial responses to actively encourage continued discussion. At times this was particularly difficult especially when the interviewee said something that the researcher found surprising.

In this study, to overcome bias it was also important to establish credibility in the eyes of the interviewees, especially given the focus on 'soft doors'. Building a rapport with the interviewees meant that their responses appeared to be relatively free from bias. This was achieved by allaying any suspicions, fears or concerns that they may have had about the research and its consequences (Sekaran, 2003). However, even though rapport was established in some cases interviewees really relaxed and opened up with their answers only when the tape recorder was turned off, which led to some difficulties in remembering exactly what had been said after the interview had finished.

As credibility was usually achieved, with reference to the involvement the researcher had in the charities sector, the researcher was often asked for her opinion by the interviewee on certain accounting matters with their charity. If the researcher had the knowledge to answer, this created a 'win-win' situation as the interviewees considered that they had gained something from the interview, and as a result the interview finished on a positive note which left the door open for future follow-up interviews. This possibly resulted in the high number of follow-up interviews, i.e. thirty-six, that this research had.

ASSURING CONFIDENTIALITY

Even though privacy was assured in the participant information sheet, interviewees in this study were still particularly concerned as to whether their charity would be identified in the research. By the researcher emphasising the privacy of their responses, most interviewees appeared to be sufficiently at ease and gave informative and truthful answers without fear of adverse consequences (Ghauri & Gronhaug, 2005; Hayes & Mattimoe, 2004; Sekaran, 2003).

The focus of this research was on the size of the charitable organisation and the four specific complexities in charities' financial statements, not the specific charitable organisation. All interviewees were assured that anonymity will be maintained and that no charity or person will be identified by name or via any reported details. The anonymity of responses was stressed as several of the interviewees were concerned about the negative view that could be given of their charity if certain facts came to light, especially as at the time of interviewing the media had focused on some charities, which had a resulting devastating impact on donations especially in the case of the Epilepsy Foundation (McCracken, 2009, 6 December).

The negative side of confidentiality was that some interviewees gave very useful information on condition that it was not included in the research, which was at times frustrating as some matters were highly applicable to the research. However, at all times the interviewee's wishes that the information was not disclosed was kept, so as not to breach their trust. However, if the facts could be confirmed in another way, for example, by publicly available information then the facts were included, with particular reference given to how the information was obtained from public sources, such as a newspaper article or from the charity's website rather than mention any interviewee's details.

QUESTIONS

As interviewees began to share their views it was important that responses were non-judgmental (Taylor & Bogdan, 1998). This was avoided by accepting all interviewees' answers and refraining from judging the appropriateness of their responses during the interview. This was particularly true in this research where some interviewees, especially in relation to the accounting method used, wanted to know whether their method were the best ones. In this situation the researcher avoided answering by stating that the researcher was trying to get an idea of what was happening in the charities sector, and thus there were no right or wrong answers.

An advantage of the semi-structured interview guide (*Appendix Three*) was that it allowed for certain themes to be discussed whilst still being flexible enough to explore emerging paths during the interview (Bedard & Gendron, 2004). This happened with the fourth complexity, the expenditure overheads ratio, as interviewees were totally against this and more concerned that their financial statements did not reflect the achievement, or otherwise, of their charity's mission. These concerns led to the fourth complexity growing from its original narrow focus on expenditure overheads to the wider view of performance reporting.

Qualitative researchers begin their studies with only loosely formulated research questions (Taylor & Bogdan, 1998), as shown in this research by the questions in the semi-structured interview guide (*Appendix Three*) being only the initial 'what are you doing' questions. Once ascertaining the meaning for the interviewee, questions were deepened to determine 'why' they acted as they did, as the key aspect of this research was probing why interviewees chose particular accounting treatments. Throughout this research there was a need to clarify and have interviewees elaborate on what they had said (Taylor & Bogdan, 1998). Even at the risk of sounding naïve I continued to probe for clarification until I was sure exactly what the interviewee meant (Robson, 1993). This was achieved by rephrasing, asking for examples or seeking clarification (Marginson, 2004).

Another aspect that needed to be considered in this research was whether participants were exaggerating or distorting their responses. Taylor and Bogdan (1998) felt that it is the responsibility of the researcher to impose cross-checks on interviewee's responses. They felt that the best way to do this is to deal with them directly by seeking

clarifications. This approach was utilised, where possible in this research, by utilising the financial statements of the Charities that the interviewee was talking about, to verify their comments. However, this option was not always feasible as several interviewees, mainly faith-based, advised the researcher that she would not be able to view the financial statements due to privacy concerns.

In this research the last question asked was a broad question ascertaining whether anything had been omitted in the interview with regards to complexities in the financial statements of charities (Bedard & Gendron, 2004). Interviewees took the opportunity to summarise their answers and often to disclose additional information, which at times proved very fruitful as interviewees brought up some very interesting facts that added depth to their information and the research data.

Near the end of the interview, to encourage snowballing, the interviewee was asked if they knew anyone else who would be prepared to be contacted for an interview. However, this, as mentioned previously, did not always meet with success, supporting Ahrens' (2004) statement that finding interview participants is a combination of subtlety and luck. Next, how the interviews were recorded is discussed.

4.5.3 Recording the interviews

The interview needs to be recorded in a variety of ways to aid validity, and several methods were used in this research including; tapes, transcripts and interview notes written either during or after the interview.

TAPE RECORDING

Twenty semi-structured interviews were recorded, as the interviewees had no objection to being taped. Unfortunately, as Hayes and Mattimoe (2004) highlights, interviewees in the charities sector are not used to a tape so are very reluctant for their interviews to be taped. The researcher did find reluctance of this by some interviewees, even with an emphasis on the positives of tape recording. If there was still unease it was safer to opt for manual note recording of the interview or even just recording part of the interview so that the interviewee felt more comfortable.

One advantage of a tape recorder was that it captured more detail than when relying on memory (Hayes & Mattimoe, 2004; Moll et al., 2006; Taylor & Bogdan, 1998). However, it was important that participants were comfortable talking in the tape recorder's presence. This was facilitated, to a certain extent, by having a small recorder

with an unobtrusive speaker which was placed slightly out of sight once permission was given to record (Patton, 2002). It still picked up the voices clearly without the participants speaking into it and at times interviewees forgot they were being taped and their answers became much more open.

In this research there was some concern that taped interviews might bias the respondents' answers because they knew that their voices were being recorded and so may hesitate to answer sensitive questions (Ghauri & Gronhaug, 2005; Hayes & Mattimoe, 2004; Sekaran, 2003). If the researcher considered that the interviewee was reluctant to answer and felt constrained by the tape recorder, the tape was turned off, which allowed interviewees the ability to speak more freely, which most did (Hayes & Mattimoe, 2004; Joannides, 2007).

Bedard and Gendron (2004) noted the need to be aware of the interviewee continuing to provide information after the tape recorder had been turned off. This was the case with several interviews where it was important to make notes of the extra information once away from the interview, or if the researcher was able to continue to record even after the formal interview was finished.

TRANSCRIPTION

Semi-structured interviews, when taped, were transcribed by a transcriber, who signed a confidentiality agreement (*Appendix Six*). The interviews were copied on to a CD and mailed to the transcriber in Hamilton. To track the delivery of the CD, the transcriber was emailed once the CD was posted and the transcriber acknowledged receipt via email. Once the interviews were transcribed, the transcription was emailed back and the CD was destroyed by the transcriber.

The transcripts were validated by listening through the tape to ensure the interviewees' nuances were correctly transcribed, which was usually the case in this research (Bedard & Gendron, 2004; O'Sullivan & O'Dwyer, 2009). However, the transcripts were not sent back to the interviewee for them to verify its accuracy, as the researcher did not want the interviewees to realise how open and at times controversial their comments were and thus seek to withdraw their interview from the research.

INTERVIEW NOTES

In this research, notes were taken in interviews for a variety of reasons. During some interviews notes were made of emerging themes, interpretations, and other data needed

to understand the meaning behind an interviewee's words (Bedard & Gendron, 2004; Taylor & Bogdan, 1998).

Several authors (Ghauri & Gronhaug, 2005; Hayes & Mattimoe, 2004) suggest that it is useful to take notes to ensure any key points are highlighted, and to highlight aspects to clarify with the interviewee. In this research, the interview guide (*Appendix Three*) was used to 'tick off' questions and add follow-up questions asked (Bedard & Gendron, 2004). Notes were also useful to check the extent to which the interviewee's response made sense and to recollect their answers should the tape recorder fail. This fortunately happened only once at the end of a very long interview.

After the interview Ghauri and Gronhaug (2005) consider it is also important to write notes on whether you are able to get all the answers, how much time it took and your opinion of the interviewee's responses, i.e. open or reserved. These details will also aid the reviewer later when the transcript is read (Hayes & Mattimoe, 2004). To facilitate this interviews were timed so that there was sufficient time to sit in the car after the interview and write notes. Sometimes the researcher drove around the corner to write the notes so as not to discomfort the interviewee.

As previously discussed many interviewees were reluctant to be in even a formal interview which meant there are seventeen informal conversations and thirty-six follow-up interviews. Interview notes were utilised afterwards to record conversations that took place outside the formal interview situation (Patton, 2002). Taylor and Bogdan (1998) considered this data is very important and should be analysed along with data collected during the formal interview process.

Further complicating the note taking was that some interviewees' information 'dried up' if I started taking brief notes as a memory prompt. This meant the period of time after the informal conversation was essential to write notes and remember phrases before the information was lost. Again, this sometimes meant driving around the corner, so that the interviewee did not see the notes being written, while the information was still fresh in the researcher's mind.

All notes made after and during the semi-structured interviews, informal conversation interviews and follow-up interviews were included in the data analysis by typing up the notes. Next, how the data from the interviews and documents was analysed is discussed.

4.6 Data Analysis:

Data analysis is the process of bringing order, structure and meaning to the mass of collected data from the document review and the interviews (Ghauri & Gronhaug, 2005). It shows the intellectual and mechanical work of the research, and has two key aspects: (1) data reduction and (2) data display before drawing or verifying conclusions (Ghauri & Gronhaug, 2005; Moll et al., 2006; O'Dwyer, 2004; Patton, 2002; Taylor & Bogdan, 1998).

4.6.1 Data reduction

Taylor and Bogdan (1998) considered that qualitative data analysis is the process of inductive reasoning, thinking and theorising. However, before analysis there needed to be some form of data reduction of all the data sources collected in this research, including interview transcripts and interview notes (Ghauri & Gronhaug, 2005; O'Dwyer, 2004).

To aid in this reduction the data collected was initially analysed by identifying similarities and differences in the reasons for the accounting treatments between charities and any other issue that was identified in the literature review. To further enhance inductive reasoning the data was further reduced by continually analysing and coding, which involved re-reading the transcripts and identifying new themes and developing further insights (Bedard & Gendron, 2004; Taylor & Bogdan, 1998). To aid this, reference was made to the hunches, interpretations and ideas recorded in the interview notes.

The next stage was to analyse the interview data with particular emphasis on the constructions inherent in each interview. This was undertaken through an inductive thematic analysis and coding of the interview transcripts utilising NVivo. Several authors consider the ability to gain some mastery over all of the data is one of the key benefits of using a computer assisted qualitative data analysis software for data reduction (Anderson-Gough, 2004; Robson, 1993). They consider that being able to scroll around a screen and at the push of several buttons being able to reproduce 'packages' of output that are relevant to the analysis much easier than looking through piles of paper.

Also Smith (2003) considered that qualitative data is vulnerable because, unlike quantitative data, there is an absence of established techniques for ensuring that data

analysis is both complete and impartial. He considered that NVivo enhances confidence in the impartiality of the analysis because: “(1) it provides a chain of evidence; (2) all cases are used in the evaluation; and (3) provides an analytical framework from which the research problem can be tested” (Smith, 2003, p. 137). Consequently, ‘NVivo’, was utilised in this study to aid data reduction.

The initial themes, based on the four complexities of the financial statements, and related problems identified in the literature review, were coded using NVivo ‘Tree Nodes’ (*Appendix Seven*). The use of NVivo enabled un-coded data to be easily identifiable which aided in identifying further patterns in the evidence as a whole (Moll et al., 2006; O’Dwyer, 2004; Robson, 1993; Taylor & Bogdan, 1998). These additional themes, which recurred in the interview evidence had not been anticipated, so were added to the preset categories of ‘Tree Nodes’. The ability, through NVivo, to display the data as an “*organised, compressed assembly of information*” (Ghauri & Gronhaug, 2005, p. 207) meant that conclusions in the interpretation of the data were able to be drawn, which is discussed next.

4.6.2 Data interpretation

Data interpretation is the critical aspect of data analysis where the research moves from description to interpretation (Taylor & Bogdan, 1998). To interpret any data not coded into a ‘Tree Node’, the data was first looked at for concepts, i.e. words or phrases in the interviews that captured the meaning behind why the interviewees acted as they did. Next the themes identified in the data reduction (*section 4.6.1*) were united by these different concepts. As different themes were identified the data was looked at for underlying similarities between them, and propositions were developed (Moll et al., 2006; O’Dwyer, 2004; Taylor & Bogdan, 1998). Ryan et. al. considers this reasoning leads to findings which must be substantiated by statements consisting of assertions, justifications and explanations to prove the conclusion (Ryan, Scapens, & Theobald, 1992).

This supports Patton (2002) who considers that these findings must be of ‘substantive significance’, which differs from the ‘statistical significance’ in quantitative studies. To determine substantive significance certain aspects need to be addressed, including:

- Does the evidence clearly support the findings, e.g. triangulation can be used to determine the strength of evidence;
- Do the findings deepen understanding, i.e. ‘verstehen’;

- Are the findings consistent with other knowledge; and
- Are the findings useful for some intended purpose, e.g. informing practice?

In order to achieve substantive significance the interview evidence supporting each theme was analysed and dominant common themes were identified. The evidence gathered into the NVivo outputs were further interpreted by considering which interview evidence best captured the spirit of the NVivo themes, in order to present the data in sufficient depth in the thesis to allow the link from the data to the underlying theoretical framework. In this research a deductive approach was taken which allowed themes to be linked to an existing theory, in this case accountability (*discussed in Chapter Five*), which provided a frame of reference for analysing these findings. These matters will be addressed in the research findings and discussions that are framed by the theoretical framework and detailed in: *Chapter Six - Professional accountability; Chapter Seven – Fiduciary accountability; Chapter Eight – Performance Accountability*. Before looking at these chapters the trustworthiness of the data needs to be evaluated.

4.7 Data Evaluation

Data evaluation is critical in qualitative research, as qualitative findings are likely to face criticisms that the work is unreliable, invalid and generally untrustworthy when compared with studies based on quantitative data, whose findings can be statistically supported (Ahrens & Chapman, 2006). Therefore, researchers analysing qualitative data have to take serious note of the potential for bias at each research stage, in particular the data collection and data analysis.

It is however important to strike a balance between, at one side, allowing the richness of the interviews by being open-minded, and having a flexible approach, which must be balanced with ensuring that the execution of this research is trustworthy (Lillis, 2006). Trustworthiness is concerned not only with the findings and whether they are ‘really’ about what they appear to be about (Patton, 2002) but also the data collection and data analysis.

Factors that consider the trustworthiness of qualitative research and the methods used to evaluate the research are varied depending on the author (Benson-Rea, 2006; Ghauri & Gronhaug, 2005; Lillis, 2006; Lincoln & Guba, 1985; Maxwell, 1992; Patton, 2002; Robson, 1993; Ryan et al., 1992). Notions of validity and reliability from positivistic studies of objective reality are unsuitable for qualitative studies which have multiple

subjective realities (Chua, 1986). Several authors suggest different evaluation criteria be used in qualitative research - credibility, transferability, dependability and confirmability (Lincoln & Guba, 1985; Robson, 1993). A comparison of the positivist and naturalist evaluation criteria is shown in *Table 4-6*.

<i>Validity criterion (Positivist)</i>	<i>Purpose</i>	<i>Confirmability Criterion (Naturalistic)</i>	<i>Purpose</i>
Internal validity	Does the indicator measure the concept?	Credibility (<i>section 4.7.1</i>)	Is the reality being investigated adequately represented?
External validity	Are sampling and research procedures representative of the population?	Transferability (<i>section 4.7.2</i>)	Are the details of the context and phenomenon understood in sufficient detail?
Reliability	Linked to validity, is the indicator stable over time and consistent with other measures?	Dependability (<i>section 4.7.3</i>)	Is the interpretation a reliable construction of the phenomenon?
Objectivity	Has the study been conducted in a methodical, judgement free way?	Confirmability (<i>section 4.7.4</i>)	Is the observed reality supported by the data, are the arguments logical?

Table 4-6 Contrasting Positivist and Naturalist evaluation (Benson-Rea, 2006)

4.7.1 Credibility

Credibility is the extent to which the reality being investigated is adequately represented and is the qualitative equivalent to the quantitative concept of ‘internal validity’. It aims to confirm that the findings are credible constructions of reality (Lillis, 2006; Lincoln & Guba, 1985; Robson, 1993; Ryan et al., 1992).

Triangulation adds to credibility by combining sources of data to the study by increasing the likelihood of measuring what the researcher intended to measure to achieve credible results (Lillis, 2006; Taylor & Bogdan, 1998). For this study, triangulation of data collection was achieved by looking at the charities’ financial statements, if these were available, and comparing them with the interview transcript on the technical accounting treatment and the prescribed generally accepted accounting practice.

Triangulation of data collection was also achieved in this study by using media interviews to triangulate the interviews and the literature review (Deegan, Rankin, & Tobin, 2002; Taylor & Bogdan, 1998). For, as Eisenberg (2008, p. 1) says:

For a decade, the print media have been the only effective mechanism for keeping non-profit organisations open and accountable. Without continued media focus on the non-profit sector, charities and foundations are likely to revert to old habits. Scandals, inappropriate behaviour and excessive compensation are still a regrettable part of our non-profit world.

Lincoln and Guba (1985) suggest 'prolonged engagement' as a method to confirm credibility, as this means the researcher is involved with the topic long enough to detect, and take account of, distortions that might otherwise creep into the data. This was seen in this research where interviews took place over a prolonged period, i.e. September 2008 to February 2010. The use of follow-up interviews also enabled the researcher to keep engaged with the interviewee for longer: for example, one interviewee was initially interviewed 8th April 2009 and the final follow-up was 24th February 2010.

Credibility was also achieved in this research by identifying different possible theories that could provide appropriate explanations of the research findings. The process of this theorisation lead to identifying accountability theory as the most likely to be relevant to the research questions identified in *section 4.2*. Next, transferability in terms of data evaluation is considered.

4.7.2 Transferability

Transferability relates to ensuring that the context of the study is understood and is the qualitative equivalent to the quantitative concept of 'external validity'. It shifts the responsibility for 'transfer' of the research findings from the researcher to the reader (Lincoln & Guba, 1985).

This study establishes transferability by providing as much information as possible about the research study to support the findings which were included in this thesis and allow 'the reader' to generalise these across the charities sector.

4.7.3 Dependability

Maxwell (1992) considered that it is important to understand phenomena from an 'emic' perspective, i.e. from the interviewees' perspective, not the researcher's. It is the qualitative equivalent to the quantitative concept of 'reliability'.

To assure the study was dependable a couple of techniques were utilised. First, a semi-structured interview guide enabled the comparability of the semi-structured interviews (*Appendix Three*) by asking the same question of each semi-structured interviewee (Patton, 1990).

Second, interviews were assessed to determine whether there was any incidence of inquirer bias, in particular if the interviewee was not allowed to finish their statement (Lincoln & Guba, 1985). Unfortunately, this study found two instances of interviews in the earlier stages of data collection where the interviewee was ‘cut-off’. Fortunately, in both cases the interviewee said that they hadn’t finished their point yet and a valuable lesson was learnt, i.e. to wait for the interviewee to finish. Finally, whether there was any conflicting evidence that disproved the claim of saturation was considered and none was found.

4.7.4 Confirmability

Confirmability is the degree to which the actual description holds true or is logical (Ghauri & Gronhaug, 2005), i.e. that the researcher is not making up or distorting things the interviewees say. Confirmability is the qualitative equivalent to the quantitative concept of ‘objectivity’.

This study assessed whether findings were grounded in the data by preparing a table that linked findings to specific interviewees, which confirmed each finding. This table also included any media interviews as well as the interviews conducted in this research as further support for the findings. The ethical implications will be discussed in the next section.

4.8 Ethical implications

In accordance with the ethical guidelines issued by the Auckland University of Technology’s Ethics Committee (AUTEK) ethical approval was required because this research involved human participants. Application was made and ethical approval was granted by AUTEK (*Appendix Two*). Their reference 08/18 dated 29 February 2008 has to be included on the Informed Consent form (*Appendix Four*), the Participant Information sheet (*Appendix Five*) and the Transcriber Confidentiality agreement (*Appendix Six*). In accordance with the ethical principles, privacy and confidentiality have been and will continue to be respected throughout this research and publication

process. This was facilitated by all participants being assigned a number to ensure their identities remain confidential. These numbers were allocated in an ‘ad hoc’ manner so that nothing could link to any interviewees’ details.

Interviewees were also assured that no identifying information would be included in the study. This was of particular concern to some interviewees, especially from umbrella organisations, that were very aware that, given the close nature of the charities sector, they could easily be recognised if any details were given.

4.9 Summary

The current research is an investigation into the complexities of transparency and understandability of the financial statements of charities. This chapter discusses why the naturalistic paradigm which was used to frame the current research was chosen. It then considered the implications of each of the five axioms of naturalistic inquiry with regards to the current research. Then the two methods of data collection, document review and interview, were analysed. How this data was metamorphosed into information was then discussed before consideration was given as to how the data was evaluated and then finally a review was made of the ethical implications of this research. This chapter determines that accountability is the ‘best fit’ for the study and this will be analysed in the next chapter.

CHAPTER 5: ACCOUNTABILITY

5.1 Introduction

Accountability is the theoretical lens through which the results of this research will be viewed. But the theoretical concept of accountability adopted here needs to be explicated first, since accountability is a wide and loosely used term found in all aspects of society.

The structure of this chapter is set out as follows. First, the chapter theorises the general view of accountability before focusing on charitable accountability. Then the chapter assesses Fishman's (2007) two key questions to be resolved regarding accountability: to whom are charities accountable, and how can accountability be discharged? Second, the chapter will examine the relationships between the accountability concept and both transparency and governance. Third, the chapter will consider different concepts of accountability before finally analysing some of the limitations of accountability.

5.2 Theorisation of Accountability

Ebrahim (2003) considers that accountability is a term that often evades clear definition. This is seen even in the dictionary where the Penguin English Dictionary (2000) gives eleven different definitions for accountability. Hyndman and McDonnell (2009) also highlight that accountability may have more than one meaning.

Hence, authors have been grappling with the definition of accountability for many years. The seminal work by Stewart (1984) gave an overview of several older definitions and identified that there were two parts to accountability prevalent in these definitions - the need for information, i.e. 'the account', and the judgement or 'the holding to account'. Roberts and Scapens (1985, p. 447) incorporated these two strands in their definition of accountability as the: "*Giving and demanding of reasons for conduct*".

The last ten years has seen an increasing body of literature on accountability. Some authors have not attempted to enter into the quagmire of definitions in their particular article but have stated accountability as a term that assumes understanding before focusing on a particular aspect of accountability such as the discharge mechanisms (Adams, 2004; Association of Chartered Certified Accountants, 2006; Brennan & Solomon, 2008; Dicke, 2002; Lee & Fisher, 2007; Lindkvist & Llewellyn, 2003; Watts,

Baard, & McNair, 2009). Other authors have theorised on the concept of accountability (Alam, 2006; Messner, 2009; Roberts, 2009).

The importance of accountability has also been seen amongst accounting bodies, with the European Financial Reporting Advisory Group, the English Accounting Standards Board and a number of other European accounting standard-setters publishing a brief paper discussing the rationale for including as a separate objective of financial reporting, accountability to stakeholders. There is a broad consensus amongst the majority of the respondents that the stewardship/accountability objective should be a separate objective of financial reporting (Accounting Standards Board, 2007b). The relevance of accountability in the charities sector is considered next.

5.2.1 Accountability in the Charities Sector

Accountability is seen as important for the charities sector in maintaining the confidence and financial support of the public by giving an account of charities' activities. However, as with the general definition of accountability, in the context of charities Kreander, Beattie & McPhail (2009, p. 166) make a similar observation on the challenge of defining accountability:

With the findings of this study, it is clear that charity accountability is complex, nuanced and not fully explained by existing theorisations.

Many authors have tried to define accountability within a charitable context (Agyemang et al., 2009; Ahmed & Wickramasinghe, 2009; Aimers & Walker, 2008; Archambault, Gariazzo, Anheier, & Salamon, 1999; Crofts, 2008; Dellaportas et al., 2008; Eisenberg, 2005; Flack, 2007a; Fowler, 2008; Jayasinghe & Soobaroyen, 2009; Keating & Frumkin, 2003; Nowland-Foreman, 2000; van Staden & Heslop, 2009; Watts et al., 2009). Other authors have attempted to define the concept of accountability within the different aspects of the wider not-for-profit sector (Bracci, 2009; Connolly & Dhanani, 2009; Connolly & Hyndman, 2003; Cordery & Baskerville, 2005; Ebrahim, 2003; Fishman, 2007; Flack & Ryan, 2004; O'Sullivan & O'Dwyer, 2009; Samkin & Schneider, 2006; Steccolini, 2004; Unerman & O'Dwyer, 2006b).

Stemming from these definitions is the notion of: being responsible for one's action; and the need to give an account to 'someone'. In 'for-profit' organisations there is a clear answerability towards shareholders. However, whilst charities may have a large variety of stakeholders (*section 5.3*) there is not always 'someone' to whom charities must explicitly account, especially if they are not a registered charity. Therefore, the

emphasis on the definition of accountability for charities must be on the need to be responsible for one's action and the account is available to anyone who seeks to review it. This leads to Fishman's (2007, p. 13) definition of accountability, which will be adopted for this study, as it emphasises the link between charitable purpose and the need to account for it:

The process by which assets devoted to charitable purpose are put to their proper purpose and information about their use is made available.

This definition is supported by Unerman & O' Dwyer (2006b, p. 351) who consider that the main purpose of accountability is

To provide mechanisms through which all those affected by an organisation's actions can demand an account from the managers of that organisation regarding how and why the organisation has acted in the manner it has.

Various accounting bodies from around the world have highlighted the importance of accountability in financial reporting. In England, the Accounting Standards Board (2007a, p. 12) considers that "*Accountability to a public benefit entity's stakeholders for the use of funds and the safekeeping of its resources is often of paramount importance*". In relation to the public sector, another not-for-profit sector, the United States goes even further by considering that accountability is the paramount objective of financial reporting (Governmental Accounting Standards Board, 1987).

As the charities sector plays such a rich and varied role in modern society, the sector's continued success is dependent upon the public's trust and confidence in their work. However, Palmer and Randall's (2002) study found that trust in the charities sector was at an all time low. Their study found that 74% of the general public surveyed agreed that there needs to be tighter control over the laws governing charity affairs and 41% expected that money given to charities would not all go to the charities' beneficiaries. This finding suggests that accountability is still of paramount importance in the charities sector.

In England and Wales one of the Charity Commission's objectives is to "*enhance the accountability of charities to donors, beneficiaries and the general public*" (Charity Commission, 2009a, p. 3). New Zealand does not have a specific accountability objective for their Charities Commission, but the Charities Commission publication on what constitutes an effective charity included accountability as one of the seven qualities of a charity: "*An effective charity understands that the public has a valid interest in it, and manages its accountabilities to its stakeholders*" (Charities Commission, 2009e, p. 3). Whilst Australia does not have a specific charities regulatory

body, their Productivity Commission (2009, p. xxxiii) acknowledges the importance of accountability: *“There is a push for greater accountability by NFPs from governments and the community”*.

Of particular importance in the New Zealand charities sector is the notion of public accountability, which arises when a charity receives money directly from the public (Ministry of Economic Development, 2009d). It is based on the belief that the taxpayer has a right *“to receive openly declared facts that may lead to public debate by the citizens and their elected representatives”* (Governmental Accounting Standards Board, 1987, p. 2). New Zealand’s Accounting Standards Review Board (2009) elaborates the public accountability concept further by including the need for an assessment on how that money is being used or managed. As proof of accountability’s importance in the charities sector, a recent bill ‘Fair Trading (Soliciting on Behalf of Charities) Amendment Bill (2009, p. 1)’ highlights that *“Public accountability is an important part of the credibility that enables people to donate with confidence”*. Next, the problems with accountability specific to the charities sector will be reviewed.

5.2.2 Accountability problems in the Charities Sector

The key problem with accountability in the charities sector stems from the notion of public trust and the issue of identifying what is an appropriate notion of accountability for charities. As Eisenberg highlights:

In a sense, nonprofits have nothing to sell but their integrity. If they undermine that, they will be in real danger of losing their soul and the public trust that sustains them. (Eisenberg, 2005, p. 159)

Accountability has thus become an increasingly important issue for charities given the recurring scandals that have plagued the sector, as well as accusations that creative accounting techniques are used to mislead funders (Khumawala & Gordon, 1997). Also, there is growing concern, especially in Europe, that terrorists may use charities as a vehicle to channel funds. This has led to the European Union developing policy steps on counter terrorism and the prevention of financial crime in relation to not-for-profits (European Foundation Centre, 2009b). Unfortunately, Connolly and Dhanani’s examination of English and Welsh charities’ annual reports in 2000/2001 and 2005/2006 found that charity accountability appears to have weakened over time (Connolly & Dhanani, 2009).

Connolly & Hyndman (2001) compared a country with a strong regulatory framework (England) with a country with a less rigorous regulatory framework (Ireland). Their

supposition was that a lack of response to requests for information indicates an unwillingness to be held accountable. In their study 38% of English medium-sized charities and 22% of Irish medium-sized charities provided usable information. They considered that possible reasons for the less extensive compliance with the Statement of Recommended Practice (Charity Commission, 2005) in Ireland were the lack of research into charity accounting practices, deficiencies in scrutiny and the absence of any statutory backing. Connolly & Hyndman went further by considering that the greater focus in England on the issue of quality in financial reporting has led to 'good practice' being adopted by many English charities (2001).

The Institute of Chartered Accountants of Scotland published a pre-election briefing highlighting the need to improve accountability in the charitable sector (The Institute of Chartered Accountants of Scotland, n.d.) which supports Dellaportas et al.'s (2008, p. ii) view that:

There is a strong belief from charity organisations that the public is entitled to receive quality information on financial performance, suggesting that increased financial disclosures would be beneficial to the charitable sector.

This directly links accountability to the publication of quality financial statements, which are the focus of this research.

However, whilst some people focus on the importance of accountability within the charities sector others consider that accountability contradicts the notion of charity. Many people who give to charities derive extra pleasure from the act of giving, or the 'warm glow of giving' (Andreoni, 1990; Brown & Caughlin, 2009). This implies a converse view which is that the accountability of a charity to donors may not be an issue. In fact spending money communicating information to discharge accountability may be a total waste of time and money for the donor, as the act of giving often bears no relationship to whether accountability has been discharged but rather the importance relates to the 'warm glow' they receive from their donations (Hyndman & McDonnell, 2009).

It is also seen by some within the charities sector that the altruistic nature of charities avoids the need for accountability, as charities are assumed to act honestly and with integrity (Connolly & Dhanani, 2009). But as Eisenberg (2005, p. 187) states:

More and more, nonprofit organizations self-righteously argue that because they provide good works, they need not be accountable to anybody – including the donors who support their work. Confidence has given way to cockiness.

This view is supported by Fishman (2007, p. 15):

The resources required to put in place an effective system of accountability would be immense, and with few exceptions it has never been thought efficient or worthwhile.

Whilst several people consider that this is justification against charitable accountability, this does not hold true given the various frauds and other misdemeanours taking place within charities. As Eisenberg (2008, p. 1) further states:

Inappropriate behaviour and excessive compensation are still a regrettable part of our world. Non-profits are fighting hard against more regulation and scrutiny, but self-reform, however attractive to a self-indulgent charity community, is not an adequate substitute for tougher regulations and enforcement.

Ken Berger of Charity Navigator puts it succinctly by saying:

We must get past the notion of doing the 'good work' with no accountability. We must get past the idea that nonprofits are too complex or unique to be measured. The nonprofit sector must get its act together and make sure it is really helping provide meaningful change in communities and people's lives. It is life or death for many of those we serve whether we are effective or not (Berger, 2009, 1 December, p. 3).

Accountability is seen as important for the charities sector in maintaining the confidence and financial support of the public by giving an account of charities' activities. As the charities sector plays such a rich and varied role in modern society, the sector's continued success is dependent upon the public's trust and confidence in their work. Thus a recognised definition of accountability, with all it entails, is an important aspect to the sector's continued success.

5.3 To whom - Stakeholders

The concept of accountability seems inextricably linked with the view that accounting should provide information to satisfy the information needs of users, i.e. stakeholders. The user-needs model is now well established as a useful basis for a conceptual framework for charity reporting (Connolly & Hyndman, 2004). Gray et al. (2006) support this view by considering that the essence of accountability lies in the relationships between charities and the stakeholder groups to whom charities are accountable.

Stakeholders are an individual, or group of individuals, who are affected by an organisation (Adams, 2004; Collier, 2008; Hung, 1998). England and Wales' Charity Commission identifies three main types of stakeholders: donors; beneficiaries and the

general public (Charity Commission, 2009a). Other authors (Accounting Standards Board, 2007a; Anthony, 1978; Bird & Morgan-Jones, 1981; Hancock, Izan, & Kilcullen, 2008; Kreander et al., 2009) have identified various external stakeholders for charities. Despite some overlap, the stakeholders can be grouped into five categories as shown in *Table 5-1*.

<i>Stakeholders of charities</i>
(1) Resource providers including: funders; donors; lenders; and creditors
(2) Governments and their agencies including regulators and oversight bodies
(3) Trustees or Officers of charities' Boards
(4) The public
(5) Beneficiaries

Table 5-1 Charitable stakeholder groups

Stakeholders can be split between upward and downward stakeholders. Upward stakeholders include regulatory bodies and financial supporters, including funders and donors, whereas downward stakeholders include beneficiaries of the charity's products or services (Connolly & Dhanani, 2009; Dhanani, 2009). As can be seen in *Table 5-2* Flack and Ryan (2004) applied a different typology by differentiating between inside and outside stakeholders. The emphasis in both typologies is on those who provide resources - or upward/inside stakeholders who are considered to have power and the authority to influence the charitable organisation - and downward/outside stakeholders who are considered to lack a voice (Connolly & Dhanani, 2009). However, in Flack and Ryan's (2004) typology beneficiaries of charities do not have a clear 'place' as they don't provide resources, but they also don't perform a review as they are the ones using the charities services or goods. Also there are differences in categorising, thus government regulators are considered an upward stakeholder by Connolly & Dhanani (2009), and conversely Flack and Ryan (2004) include them as outside stakeholders. Thus, to limit confusion this study will focus on the more commonly used terms of upward/downward (Connolly & Dhanani, 2009; Dhanani, 2009) rather than inside/outside (Flack & Ryan, 2004).

<i>Inside Stakeholders</i> <i>(Providers of resources)</i>	<i>Outside Stakeholders</i> <i>(Parties performing a review or oversight function)</i>
<ul style="list-style-type: none"> • Board members • Members • Employees • Professional staff • Paid workers • Volunteers • Purchasers/users of services • Creditors • Suppliers of goods and services • Donors • Private grant makers • Government funders 	<ul style="list-style-type: none"> • Government regulators (accountability agents for general public) • Media (accountability ‘watchdog’ for general public) • Professional bodies • Labour unions • Employer groups • Analysts and advisors • Special interest groups/minorities • Charity ‘watchdog’ organizations • Community/general public

Table 5-2 Typology of charitable stakeholders (Flack & Ryan, 2004)

O’Dwyer & Unerman’s (2008) study distinguishes accountability further by revealing that while charity managers favoured the development of holistic accountability mechanisms that exhibit accountability to a wide range of stakeholders, an hierarchical conception of accountability that privileges a narrow range of (potentially) powerful stakeholders has begun to dominate accountability practice. This was later supported by Connolly, Hyndman & McMahon (2009), in an extensive study for the England and Wales Charity Commission and the Office of the Scottish Charity Regulator. They identified funders as the key or primary stakeholders for all charities regardless of their size, jurisdiction and nature of activities.

However, not all funders are of equal size or importance and other researchers have suggested that the form and extent of the accountability may vary depending on the type of donor and charity (Hyndman & McDonnell, 2009). Cordery (2008) aimed to meet the challenge posed by Ebrahim (2003) by undertaking an integrated study of how particular not-for-profit organisations dealt with multiple and sometimes competing accountability demands from their stakeholders. She found that stakeholders expected Primary Health Organisations to prioritise either community or their funding and service providers, which gave rise to possible conflicting demands that led to suggestions for mechanisms to balance multiple stakeholders (Cordery, 2008).

The myriad of definitions of accountability are due in no small part to the multiple accountabilities these various stakeholders demand (Hyndman & McDonnell, 2009). This could lead to an over-provision, or under-provision of information if each user

assumes the other is monitoring the charity (Hyndman & McDonnell, 2009). Hyndman & McDonnell (2009) also consider that an important role of charities governance is to determine what accountability relationships exist and how this accountability should be discharged. The issue of how this accountability can be discharged in terms of information and monitoring are addressed next.

5.4 Discharge of Accountability

Implicit in the concept of accountability is the question of what the accountor is accountable for in order to discharge accountability (Cordery, 2008; Patton, 1992). The discharge of accountability, at a minimum, involves a required transfer of information and the important thing is what form that ‘account’ takes (Connolly & Hyndman, 2003; Cordery, 2008; Hyndman & McDonnell, 2009).

For Christians, ensuring charity accountability was discharged was perhaps easier in the middle ages in England, where the concern by accountees was that the failure to be charitable would lead to “*eternal damnation*” (Fishman, 2007, p. 14). Islam has also developed its own concept of accountability (Taklif) where everyone must accept all the duties and liabilities as well as the benefits of any ownership or responsibility entrusted unto them and this would be assessed on the ‘Day of Judgement’ (Jayasinghe & Soobaroyen, 2009).

Unfortunately, stakeholders cannot rely on ‘eternal damnation’ to ensure charities discharge accountability and with the major financial scandals involving charities, for example embezzlement in United Way of America, there has been increasing concerns raised about the accountability of charities in relation to the adequacy of current reporting and accountability mechanisms (Keating & Frumkin, 2003) which, will next be examined.

5.4.1 Accountability Documents

Upward accountability must show ‘inside’ stakeholders how charitable organisations used and spent their money and whether this was an appropriate use of their funds (Agyemang et al., 2009). Accountability documents include: financial statements; annual reports and performance documents (Agyemang et al., 2009), all of which will be reviewed next.

5.4.1.1 *Financial Statements*

Financial statements enable their users to determine how the charity's funds were received and spent (Connolly & Dhanani, 2009). In fact the concept of accountability seems inextricably linked with the view that financial statements should provide information to satisfy the information needs of users (Connolly & Hyndman, 2004). This underlines the definition of accounting as "*the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information*" (American Accounting Association, 1966, p. 1). The American Accounting Association (1966) also developed four guidelines for communicating this information: (1) Appropriateness to expected use; (2) Disclosure of significant relationships; (3) Uniformity of practices within and among entities; and (4) Consistency of practices through time.

The fourth guideline is particularly relevant to the charities sector, as an English study of 1,000 users of annual reports (Charity Commission, 2004) found that 60% of respondents considered the ability to compare important information between charitable organisations would affect their decision about which organisation to support. This reinforces Connolly and Hyndman's (2001) supposition that the dissemination of accounting information is an important aspect of discharging accountability. In particular, financial statements are generally recognised as key documents in the discharge of accountability to upward stakeholders (Connolly & Hyndman, 2004).

Accurate and relevant information about organisations in the charities sector is essential for real accountability and for trust and confidence in the sector (Charity Commission, 2004). Access to charities' financial statements has recently become possible in New Zealand due to the development of a Charities Register. This register will ultimately provide public access to the financial accounts of all registered charities (Charities Commission, 2006f). This will support Brandeis (cited in Fishman, 2007, p. 123) who said in 1914 that "*sunlight is the best disinfectant*". This was reiterated by Fisher (2006a, p. 1) who felt that "*opening the books*" of charities will provide more transparency for contributors to charities.

Various authors have (Connolly & Dhanani, 2009; Connolly & Hyndman, 2003) highlighted the limited role financial statements actually take in discharging accountability, as they do not explicitly link to the success, or otherwise, of the charity's activities. This supports Cordery & Baskerville (2005) who consider that beneficiaries often would have their accountability better met with comparable non-financial

performance reporting rather than financial reporting through financial statements. In fact Hyndman (2008) goes a step further by considering that:

In the absence of performance information the concept of accountability and indeed the whole democratic process is simply a sham. (Hyndman, 2008, slide 12)

Connolly & Hyndman (2003) consider that there is a tendency to emphasise the discharge of accountability through financial statements at the expense of wider performance information. The lack of reliance on performance information will be discussed in terms of the findings of this research in *Chapter Eight*.

The ability to discharge accountability also depends on the financial statements being transparent and understandable which, as discussed in *Chapter Three*, is not always the case. This research aims to clarify the reasons for the different accounting treatments that impact on users' abilities to understand and compare charities' financial statements. Another problem with financial statements is the oft held view that no one looks at the information so the statements are pointless.

5.4.1.2 *Annual Report*

In New Zealand the different legal structures and the rules governing each particular charity dictate whether the charity is required to prepare an annual report. For registered charities, section 41 of the Charities Act 2005 specifies the duty to prepare Annual Returns, which have financial statements attached to them, but there is no explicit duty to prepare annual reports. In relation to incorporated societies, section 23 of the Incorporated Societies Act 1908 states the requirement not only to prepare financial statements but submit them annually to the Incorporated Societies Registrar. By contrast the Charitable Trusts Act 1957 makes no mention of financial statements or annual reports. Thus the only legal charitable structures that are required by statute to produce an annual report are charities registered as companies. Section 208 of the Companies Act 1993 obligates a company to prepare an annual report, with section 211 providing details of its required content.

Whilst it is common practice for some of the larger New Zealand charities to prepare annual reports and have them available on their website, for example the Cancer Society of New Zealand (http://www.cancernz.org.nz/assets/files/docs/csnz_ar-2009.pdf), this is not common for small to medium sized New Zealand charities.

The situation is vastly different in England and Wales where there are detailed legal requirements (The Charities (Accounts and Reports) Regulations 2008) which stipulate

what should be included in charities' annual reports (Charity Commission, 2009b). However, a recent study found that a disappointing 36% of English charities contacted did not fulfil their statutory obligation and provide a copy of their annual report upon request (Connolly & Dhanani, 2009). Despite this, the annual report is recognised as a key document in the discharge of accountability to upward stakeholders (Connolly & Hyndman, 2004; Flack & Ryan, 2004; Steccolini, 2004).

The role of annual reports in the Australian charities sector was specifically investigated by Flack (2007b). In Australia, information on charities and their accountability is not available to the general public or to the Australian government, due to their current regulatory environment (Flack, 2007a), although Flack (2007b) reinforced the importance of the annual report in discharging accountability.

Annual reports are primarily aimed at upward, rather than downward stakeholders as well as the public at large, even if, as with the financial statements previously mentioned, they are not read by stakeholders (Connolly & Dhanani, 2009). This was supported by Steccolini (2004) whose study on Italian Local Government found that annual reports are used to discharge accountability to stakeholders, even when it is not clear that they are actually read.

However, Connolly & Dhanani's (2009) recent study found that annual reports play a limited role in discharging accountability unless the financial information is substantiated with non-financial narrative information. Connolly & Dhanani (2009, p. 61) found that the content of the annual report "*is driven by what makes a 'good story' or an 'interesting read'*" rather than by ensuring transparent accountability. This was also supported by Connolly, Hyndman and McMahon's (2009) study which found that a range of sector-related publications (Charity Commission, 2004; Connolly & Hyndman, 2003; Opinion Leader Research, 2005) encourage a 'story' approach to reporting focusing on the performance of the charity. In line with this, the use of performance reports as an instrument of accountability will be analysed next.

5.4.1.3 Performance reports

Performance reports are reports that provide primarily non-financial information of the achievement, or otherwise, of charities' objectives (Controller and Auditor-General, 2008). Lee & Fisher's (2007) study of the Australian Public Sector considered that they added an extra dimension to the discharge of accountability by identifying the need for

appropriate performance information to monitor programme performance, facilitate resource allocation, and improve the efficiency and quality of service delivery.

At the same time as Lee & Fisher's (2007) article, the New Zealand Institute of Chartered Accountants released a technical practice aid on performance reporting called 'Service Performance Reporting' (New Zealand Institute of Chartered Accountants, 2007b) which encourages charities to report on their service performance usually via non-financial information (*paragraph 1.4*). However, with no legislative requirement for charities to produce annual reports, let alone performance reports, it is perhaps hardly surprising that this standard has had little impact in the New Zealand charities sector.

This contrasts with the public sector in New Zealand, which has a strong emphasis on performance reporting. In fact the New Zealand Controller and Auditor-General (2008) considers the primary document for the discharge of accountability to be the performance reports included in the annual report.

Unlike the charities sector, the public sector has a legislative requirement under the Crown Entities Act 2004 to produce not only an annual report but performance reports. Section 150 imposes an obligation for public sector organisations to prepare and publish annual reports. Under section 151 this annual report must include a statement of service performance. Section 151(2) further stipulates that the annual report must provide information on the organisation's operation and performance, which must include an assessment against the intentions and measures set out in the statement of intent. The purpose of the Statement of Intent is to promote the public accountability of public sector organisations (section 138).

Australia is in a state of flux at the moment with regards to performance whilst the recommendations of the Senate Standing Committee on Economics (2008) are considered by the Australian Government. One priority recommendation is to implement a standard chart of accounts for use by all government departments and Not-For-Profit Organisations. Whilst this has focused on financial information, the Committee further recommends that a new disclosure regime be introduced, which contains elements of non-financial and financial reporting. One of the concerns that the writer has with the standard chart of accounts is that the use of a 'one-size fits all' scenario might not reflect the complex and diverse charities sector.

England and Wales have attempted to improve information about the work of their larger charities by incorporating a 'Summary Information Return' in their Annual Return (Charity Commission, 2009e). These returns include information on the charity's objectives and achievements; fundraising activities; activity costs; and financial health. Charities also need to stipulate how their performance in the current year will affect the charity in the future. Their legislation also is explicit about the need for performance information, as can be seen in section 41(2) (b) of the Charities (Accounts and Reports) Regulations 2008 section 41(2) (b) (i)-(iii) which states that the following must be included:

Aims and objectives of the charity; the strategies adopted; the significant activities undertaken to achieve the aims and objectives; and the achievements of the charity in relation to the aims and objectives.

In New Zealand the Controller and Auditor-General (2008) released a report entitled '*The Auditor-General's observations on the quality of performance reporting*'. In this he commented on the need to lift the quality of performance reporting in the public sector to a satisfactory level since the lack of quality represents a significant weakness in the public sector's accountability to its stakeholders (Controller and Auditor-General, 2008). He found that many performance reports:

do not seem to set out coherent performance frameworks showing logical links from the medium-term outcomes information and organisational strategies to the annual output information (Controller and Auditor-General, 2008, p. 7).

It is disappointing that, twenty years after the New Zealand public sector moved to performance reporting, there is a lack of progress by the sector in improving what they report. The charities sector can learn from this and in particular take notice of the Controller and Auditor-General's report on his observations on the quality of performance reporting, which includes:

a properly set direction; good measurement systems; and accessible reporting of significant information while meeting cost-benefit tests (Controller and Auditor-General, 2008, p. 37).

Having outlined the accountability documents that support the discharge of accountability, next, the mechanisms by which accountability is discharged will be reviewed.

5.4.2 Accountability Mechanisms

Accountability mechanisms are varied and can range from the monitoring of charities performed by: charities regulatory bodies; rating agencies; auditors; independent

examiners and the Charities' Board which was discussed in *Chapter Two (section 2.6)*. Each mechanism will be analysed here in terms of its impact on accountability.

5.4.2.1 Charities Regulatory Bodies

In England and Wales the Charity Commission has a specific function to:

identify and investigate apparent misconduct or mismanagement in the administration of charities, and to take appropriate remedial or protective action (Charity Commission, 2009a, p. 3).

They consider that an important part of monitoring is to raise awareness of compliance requirements and risks that charities need to guard against (Charity Commission, 2009a). However, the Charity Commission considers that they have inadequate resources to regularly review all the charity accounts they receive, thus if there is no specific complaint that triggers investigation it is possible for charities to submit very poor financial statements (Morgan, 2009b).

While the Charity Commission has been around for over one hundred years their 'Compliance Monitoring Unit' only became fully operational since 2008. Its establishment was in answer to the increasing concern over the need for greater oversight of charities. As highlighted in *Chapter Two (section 2.6.1)* the Charity Commission publishes an overview of the themes and lessons learnt from their monitoring since the unit was started, as they consider this raises awareness of the risks facing charities (Charity Commission, 2008b, 2009a, 2010e). It is interesting that Scotland's recently established Office of the Scottish Charity Regulator (OSCR) is proposing to allocate considerable resources to reviewing accounts and conducting investigations (Morgan, 2009b). This may lead to an increase of emphasis in England and Wales which could see the monitoring unit increase from their current eight staff members (Charity Commission, 2009a).

The Charity Commission uses a variety of methods to monitor or investigate 'regulatory compliance cases' and 'statutory inquiries' (Charity Commission, 2010a, 2010f). The Charity Commission also rely on charities' trustees to report serious incidents within their charities and in the 2008-2009 year the Charity Commission received reports of two hundred and sixty-one serious incidents, of which 54% related to fraud (Charity Commission, 2009a).

With regards to regulatory cases, the Charity Commission publishes the reports if there is significant public interest in the issues involved and when there are lessons that other

charities can learn from them (Charity Commission, 2010d). This can be seen in the recent publication of the Eelapatheeswarar Aalayam case which was published to raise awareness of “*the responsibility of charity trustees to safeguard their charity from the risk of abuse, including terrorist abuse*” (Charity Commission, 2010c, p. 5). In relation to inquiry reports the commission reports the outcomes of all formal inquiries unless publication would be detrimental to the charities sector (Charity Commission, 2010b).

In Australia, the Australian Taxation Office (ATO) monitors the sector by investigating the eligibility of taxation concessions. The ATO work on the premise that charities are highly compliant and seek to abide by the requirements of their special taxation status. Accordingly, it will review only 200 non-profit entities to determine continued eligibility for concessions in the 2009-2010 tax year (Australian Taxation Office, 2009). To aid charities, the ATO publishes a non-profit news service which highlights the common errors they have identified (Australian Taxation Office, 2010) .

By comparison, New Zealand is in its infancy in terms of monitoring the charities sector. This can be seen on the New Zealand Charities Commission web site (<http://www.charities.govt.nz/about/index.html>) which states:

The Commission also investigates and will shortly be monitoring charities.

Currently, the Charities Commission appears to be focusing on investigating individual complaints about charities rather than monitoring Charities’ Annual Returns and financial statements to ensure charities are doing what their rules require. As Trevor Garret, the Commission’s Chief Executive Commission has stated on Television New Zealand’s Close-up programme:

Bear in mind we’ve registered close to 23,000 organisations, that’s 23,000 sets of financial statements that are going to come in every year. So we’re not necessarily going to look at every single organisation (Television New Zealand, 27 July 2009).

To utilise the Charities Commission as a mechanism for discharging accountability, it is essential that the Commission develop a structured monitoring service similar to those of the England and Wales Charity Commission or the Australian Taxation office, which proactively monitors accountability within the charities sector.

5.4.2.2 Rating agencies

Another mechanism is the use of rating agencies as a tool for disseminating accountability information in an easily accessible format via the internet. In England and Wales the Charity Commission supported the establishment of GuideStar UK,

which was set up in 2003. Charity accountability is discharged through disclosures on the Charities' aims, objectives, activities, performance, and future plans (Dhanani, 2009). GuideStar UK looks only at the accountability practice of charities whose annual income is greater than GBP25 million. GuideStar is considered credible because all relevant information is sourced from the charities' annual reports. Additionally, charities have the opportunity to update and amend the information. This needs to be tightly controlled to ensure charities are not 'improving' their information (Dhanani, 2009).

As discussed in *Chapter Two (section 2.6.4)*, in Australia and New Zealand there have been recommendations to the respective governments that a rating agency be introduced (Philanthropy New Zealand, 2006; Senate Standing Committee on Economics, 2008). It is hoped that the establishment of a rating agency is actively supported by the Government in these countries, as the accessibility of information in a consistent format will go some way towards discharging accountability by ensuring transparent and understandable information is available. This contrasts with the current situation in New Zealand where the financial information available through the New Zealand Charities Commission is in numerous formats, resulting in the Annual Return data being inconsistent and incomparable and at times bearing no obvious relationship to the financial statements attached to the Annual Return.

5.4.2.3 Assurance

One type of assurance - auditors are another form of accountability mechanism, as they enhance the credibility of information disclosed in charities' financial statements by providing an independent view of the financial statements. This was supported in the study by Fletcher (2008) who found that all funders that were interviewed preferred audited accounts and the key reason given for this preference centred on the reassurance offered by an independent perspective.

New Zealand's Department of Internal Affairs' Community resource kit identifies four types of independent monitoring of communities groups, such as charities, two of which are audit related, in their publication 'Community Resource Kit':

- (1) Audit by a chartered accountant with a certificate of public practice;
- (2) Audit by an accountant e.g. a retired accountant or an accounting technician;
- (3) Review engagement; and
- (4) Independent verification (Department of Internal Affairs, 2006 section 6, p. 8).

The September 2009 review of New Zealand’s financial reporting framework, raised the importance of considering what is the most appropriate ‘assurance engagement’. NZICA’s (2010) Explanatory Foreword to Engagement Standards in paragraph 12 defines an assurance engagement where a conclusion is expressed:

In the form of an opinion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

The Ministry of Economic Development (2009d) proposed that charities that are publicly accountable, i.e. collect money from the public, should be required to complete an assurance engagement unless their small size means that the assurance-related benefits to users are likely to be outweighed by the costs of a review engagement. The Accounting Standards Review Board’s tentative proposal (*Table 5-3*) is that in order to match costs and benefits Tiers 1 and 2 would be required to obtain an audit engagement, but Tier 3 would be able to have a review (Accounting Standards Review Board, 2009).

Tiers Based Upon Operating Expenditure	Quality assurance proposed
Tier 1: Expenditure \geq NZD10 million.	Audit
Tier 2: Expenditure \leq NZD10 million but \geq NZD1 million.	Audit
Tier 3: Expenditure \leq NZD1 million but \geq NZD20,000.	Review if expenditure \geq NZD100,000 and \leq NZD1 million. No audit or review if expenditure \leq \$100,000
Below Tier 3: Expenditure equal to or Less than NZD20,000	No assurance required

Table 5-3 Levels of assurance (Cordery & Sinclair, 2009)

In England and Wales charities must be audited if either their gross income exceeds GBP500,000 (i.e. NZD2.8 million) or their assets exceed GBP2.8 million (i.e. NZD5.7 million) (Charity Commission, 2008c). The Auditing Practices Board also offers specific guidance for auditors of charities to aid them in their audit (Auditing Practices Board, 2009).

In contrast, Australia does not have a prescribed level of auditing for charities. The determination of whether an audit is required depends upon the legal structure of the charity, the two main ones being incorporated associations and company limited by guarantee. Incorporated associations are governed by the Associations Incorporation Act in their state of incorporation and, except in the states of New South Wales and

Western Australia, all financial statements must be audited (Institute of Chartered Accountants in Australia, 2009a). For companies, the requirement for audit arises from the Corporations Act 2001. For other types of charitable legal structures, for example trusts, the requirement for audit may be written within the founding document, i.e. trust deed, charter or specific enacting legislation (Institute of Chartered Accountants in Australia, 2006, 2007, 2009a).

Regardless of the requirements in the previous mentioned countries, several studies have highlighted problems with auditors of charities (Kitching, 2009; Mohiyaddin, 2009; Newberry, 1992; Palmer et al., 2001; Rees & Dixon, 1983). These problems impact on audit quality which affects donor decisions. Kitching (2009) found that donors give more to charities aligned with the large chartered accounting firms, as large firms were deemed to produce a higher quality audit (Kitching, 2009). These findings were also supported in a recent New Zealand study by Mohiyaddin (2009).

However, Mohiyaddin (2009) also found that most New Zealand charities are small charities and cannot afford the larger chartered accounting firms fees. Her study found that small firm auditors seem to audit charities without full adherence to the auditing standards and financial reporting standards. This was supported by earlier New Zealand studies (Newberry, 1992; Rees & Dixon, 1983) which found numerous problems. In particular, Rees & Dixon (1983) found major independence issues, since 58% of auditors in their study prepared the financial statements that they were auditing.

Problems in auditing compliance have been raised by the New Zealand Government as a contributing factor to several recent finance company failures (Power, 2009). Simon Power, the Minister of Commerce, is proposing to establish a system that would limit the carrying out of statutory audits to licensed individuals with demonstrated auditor-specific capabilities (Ministry of Economic Development, 2009a). Unfortunately, statutory audits do not currently include charities, who are currently specifically excluded from the new oversight and licensing systems, unless they are issuers (Ministry of Economic Development, 2009a). It is concerning that the introduction of a 'statutory audit' will lead to two different levels of auditing. This seems to be implying that auditors need to be of good quality if they are auditing finance companies, but not necessarily of the same quality if auditing charities. This is disappointing given the identified problems with charities' auditors. If stakeholders wish to rely on the audit report as a mechanism for discharging accountability, there needs to be an improvement in the quality of charitable auditing.

Even without the issue of new oversight rules audits are becoming increasingly difficult to obtain at a price all charities can afford (Prangnell, 2007). The honorary charity auditor is in danger of becoming extinct as the audit risk is now seen by many as too great (Fisher, 2007b). Compounding this is the issue that, unless explicitly specified by the Charities' rules, e.g. constitution, trust deed, legislation, anyone can carry out an audit. Currently, it is only if auditors are members of NZICA that audit standards and ethical codes must apply to ensure they are competent in what they do (Fisher & Davis, 2007).

In England and Wales an examination of the financial statements can be undertaken by an independent examiner, rather than an auditor, if a charity's gross income is between GBP100,000 and GBP500,000 (Association of Charity Independent Examiners, 2010; Charity Commission, 2009d). Independent Examiners are recognised as a distinct profession separate from accountants and auditors and since 1999 they have had their own professional organisation, the Association of Charity Independent Examiners (ACIE). The ACIE is charged with ensuring that Independent Examiners are independent and have the ability and the practical experience to conduct a competent examination of charities' accounts (Association of Charity Independent Examiners, 2010). However, this structure may not be a feasible option for a small country such as New Zealand to emulate, as it would require the development of a whole new qualification and professional category.

In New Zealand, the Department of Internal Affairs has tried to lessen the need for auditors by introducing the levels of audit and financial review mentioned previously. The two levels of interest here are: (3) review engagement and (4) independent verification (Department of Internal Affairs, 2006) .

A review engagement is an examination of the financial statements to assess whether the reviewer can identify anything that causes them to believe the financial statements do not represent a true and fair view (New Zealand Institute of Chartered Accountants, 2003b). Whilst a review may be cheaper and more relevant than an audit (Fisher, 2007a) they unfortunately are not fully understood, as evidenced in the recent newspaper article entitled '*Feltex failed by accounting firm, court hears*', where Ernst & Young had to explain that a review gave only limited assurance, meaning that there were less detailed investigations undertaken during a review compared with an audit (Nordovist & Gregor, 2010).

The fourth level of independent examination, introduced by the Department of Internal Affairs (2006), is that of 'independent verification'. This is performed by someone who is independent of the charity and has a reasonable understanding of accounting, such as a bank manager. This form of verification is considered sufficient for smaller community groups, i.e. with less than \$40,000 total annual turnover, where their rules/constitution does not specify any requirement for an audit (Department of Internal Affairs, 2006). The concern with 'independent verification' is that of quality - who assesses that the bank manager has a reasonable knowledge of accounting?

Eisenberg (2005, p. 153) states "*The Buck Stops with the Board*" which, is the next accountability mechanism that will be examined here.

5.4.2.4 Charities Boards

The introduction of the Charities Register in New Zealand has seen an increased visibility on who are the 'officers' of the charity. 'Officers' include board members and are those involved in how the charity is governed. As Eisenberg (2005, p. 153) highlights they "*are the first and last line of defense against poor performance, corruption, and lack of accountability*". So it is all the more disappointing that charities can often be let down by the very people who mean well i.e. the people sitting round the 'table' (Siveter, 2004).

This was seen in the case of Corran School, a New Zealand Anglican girls' school, which was also a registered charity. Due to financial difficulties Corran's Board incorporated the school into St Kentigern, a Presbyterian school of different religious faith. What particularly upset the parents was the school Board's electing not to reveal the extent of the school's dire financial situation so that something could be done about it before announcing the 'merger' (Smith, 2009). "*The Board has let us down, there's no question the damage is done, and we cannot reverse that*" (Rushworth, 2009, p. 21). A postscript to this situation was that the Charities Commission has now deregistered the school, due to its inability to file Annual Returns which would have illuminated their financial affairs. In this example the school Board had not exercised care, by neither communicating to their key stakeholders, including parents, nor ensuring proper financial management of the school. It is hoped that the increased exposure of charities' details on the register will, in future, limit these occurrences and lead to an improvement in Boards' performance to enhance their use as an effective mechanism to discharge accountability.

This section has considered how accountability can be discharged by charities first by looking at accountability documents, such as financial statements, that can be used by charities to discharge their accountability to their stakeholders. Also four accountability mechanisms were considered: charities regulatory bodies, rating agencies, assurance and charities boards looking at the role each mechanism played in discharging accountability. Next, the relationships between accountability and transparency and accountability and governance are reviewed to consider whether they shed any further light on accountability.

5.5 Relationships

It is important to contextualise the accountability concept with both transparency and governance, as at times these terminologies are used interchangeably. First, the relationship between transparency and accountability is considered.

5.5.1 Transparency

The relationship between accountability and transparency is clear in the New Zealand Charities Commission's (2009e, p. 3) explanation of the quality of an effective charity, i.e. accountability and transparency, which they link together by highlighting that a charity needs to:

Manage its accountabilities to its stakeholders and to the public in a way that is timely, transparent and understandable.

The work of two authors (Eisenberg, 2005; Roberts, 2009) sheds further light on this relationship. Firstly, Eisenberg (2005, p. 232), who considers that transparency is a subset of accountability or rather:

Transparency is the cornerstone of accountability.

Roberts (2009, p. 957) takes this a step further by considering that transparency is not just the cornerstone but a mechanism of accountability which:

Casts light upon what would otherwise remain obscure or invisible.

Transparency then becomes accountability by turning measures into targets (Roberts, 2009). Thus the development of accountability increases the transparency of charitable organisations (Roberts, 2009). Hence, transparency is an essential part of accountability and they are forever integral to each other.

The importance of transparency and accountability in charities is highlighted in the following quote:

What are the major areas of concern with which the nonprofit community must begin to grapple? The most important by far is the pressing need for transparency and public accountability. (Eisenberg, 2005, p. 229)

This importance is seen in New Zealand where transparency and accountability are two of the qualities of being an effective charity (Charities Commission, 2009e). Also in Australia the Senate Standing Committee on Economics (2008, p. 130) considered that:

It is in the public interest for NFP organisations to be more transparent and accountable.

England and Wales have the ImpACT (i.e. Improving Accountability, Clarity and Transparency) Coalition (<http://www.impactcoalition.org.uk/>) which represents 280 charities whose specific goal is to work together to improve transparency and accountability and preserve public trust in the charitable sector (ImpACT Coalition, 2009). Also, England and Wales Charity Commission has committed itself to seeking further improvements in the transparency and accountability of charities (Hillsdon, 2003).

Many authors have linked transparency and accountability but examining just how they relate, if at all, may shed further light on accountability (Berger, 2009, 19 October; Charities Commission, 2009e; Charity Commission, 2004; Dellaportas et al., 2008; Dunne, 2009; Eisenberg, 2005; European Commission, 2005a, 2005b; European Foundation Centre, 2009a, 2009b; Hillsdon, 2003; Hyndman, 2008; Hyndman & McDonnell, 2009; ImpACT Coalition, 2009; Kreander et al., 2009; Roberts, 2009; Senate Standing Committee on Economics, 2008). Next, we will look at how governance and accountability relate.

5.5.2 Governance

Just as with the complexities of accountability, Hyndman & McDonnell (2009) highlight that the concept of 'governance' is unclear, with a myriad of ideas placed under the umbrella of 'good governance'. This makes it difficult to determine the relationship, if any, that exists between accountability and governance. However, a review of various authors' (Eisenberg, 2008; Fishman, 2007; Flack & Ryan, 2004; Hyndman & McDonnell, 2009; International Federation of Accountants, 2009b; Keating & Frumkin, 2003; Palmer & Randall, 2002) writings about accountability and governance reveals three distinct views: (1) accountability and governance existing alongside each other; (2) accountability as a subset of governance; and (3) governance as a subset of accountability. Each of these will be analysed in turn.

Palmer & Randall (2002) summarise several codes of good practice into eight dimensions: (1) Effectiveness; (2) *Accountability*; (3) Standards; (4) User involvement; (5) *Governance*; (6) Volunteers; (7) Equality and fairness; and (8) Staff management. Here, accountability and governance co-exist as two separate parts of the whole picture of good practice.

Palmer & Randall (2002, p. 31) define accountability as “*evaluating effectiveness and performance, dealing with complaints fairly and communicating to all stakeholders whose responsibility will be fulfilled*” whereas they define governance as “*having a systematic and open process for making appointments to the governing body, setting out the roles and responsibilities of members*”. Palmer & Randall’s (2002) definition of governance is quite narrow and appears to focus on the appointments to charities governing bodies and ensuring those appointed are clear on their responsibilities.

By contrast, another view of governance, as shown in *Figure 5-1*, has two dimensions: conformance, and performance where accountability is a subset of conformance (International Federation of Accountants, 2009b). However, IFAC (2009b, p. 19) also considers that the principles of: integrity; *accountability*; and transparency govern the processes involved with providing information to upward stakeholders. This repositions accountability as part of the whole organisation rather than a subset of the conformance dimension. This viewpoint is implicitly supported by IFAC, offering two definitions of accountability. First, a narrow focus of accountability as the responsibility to stakeholders, i.e. part of conformance; and second, a wider view of accountability as the process whereby entities are:

Responsible for their decisions and actions, including their stewardship of public funds and all aspects of performance; and submit themselves to appropriate external scrutiny (International Federation of Accountants, 2009b, p. 20).

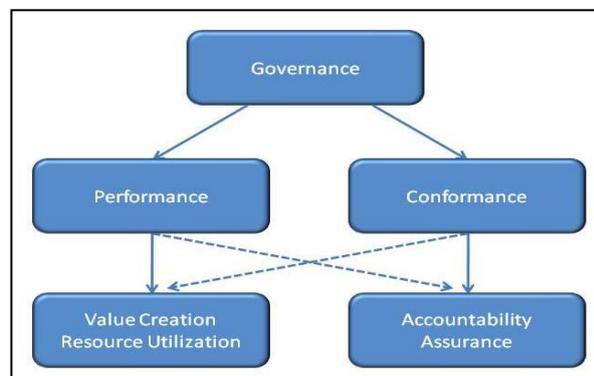


Figure 5-1 Governance Framework (IFAC, 2009)

Research (Eisenberg, 2008; Fishman, 2007; Flack & Ryan, 2004; Keating & Frumkin, 2003) focused on charities and the wider NFP sector tend to look at governance as a

subset of good accountability practice or even a category of accountability. This is illustrated by the European Foundation Centre and Council on Foundations (2007) who consider good governance as one of the nine accountability practices needed for good international philanthropy. This is also seen in Fishman's (2007) definition of accountability which encompasses six different aspects including good governance. Governance as a subset of accountability is also evident in Keating & Frumkin's (2003) and Flack & Ryan's (2004) definitions of accountability.

Hence, governance is seen as an integral part of accountability, for without it charities will not maintain the confidence and financial support of the public (Palmer & Randall, 2002). Next, how the different concepts of accountability are analysed in this research will be considered.

5.6 Concepts of accountability

In this research the focus is on the theoretical nature of accountability as it relates to charities, which was discussed in *section 5.2* however, some of the common concepts of accountability used recently in studies of charities conceptualise the different concepts of accountability, and their inclusion in this research needs to be considered (Adams, 2004; Agyemang et al., 2009; Ahmed & Wickramasinghe, 2009; Association of Chartered Certified Accountants, 2006; Connolly & Dhanani, 2009; Connolly & Hyndman, 2003; Cordery, 2008; Cordery & Baskerville, 2005; Dellaportas et al., 2008; Dhanani, 2009; Flack & Ryan, 2004; Hyndman & McDonnell, 2009; International Federation of Accountants, 2008; Jayasinghe & Soobaroyen, 2009; Keating & Frumkin, 2003; Lindkvist & Llewellyn, 2003; Messner, 2009; Narayan, 2006; O'Dwyer & Unerman, 2008; Steccolini, 2004; Stewart, 1984).

Some of the concepts of accountability highlighted in *Table 5-4* are interchangeable and others overlap, so their use in this research needs to be clearly articulated. Stewart (1984) suggests that concepts of accountability can be set out as a 'ladder of accountability' ranging from accountability by standards to accountability by judgement.

<i>Concepts (with definitions)</i>	<i>References</i>
<i>Downward</i> to beneficiary groups and clients who use their services.	(Adams, 2004; Agyemang et al., 2009; Ahmed & Wickramasinghe, 2009; Association of Chartered Certified Accountants, 2006; Connolly & Dhanani, 2009; Cordery, 2008; Dhanani, 2009; Jayasinghe & Soobaroyen, 2009; O'Dwyer & Unerman, 2008)
<i>Fiduciary</i> which emphasises probity, compliance and control and is concerned with the avoidance of misconduct.	(Ahmed & Wickramasinghe, 2009; Connolly & Dhanani, 2009; Steccolini, 2004; Stewart, 1984)
<i>Financial</i> where the quality of financial statements are judged in terms of their compliance with GAAP.	(Connolly & Dhanani, 2009; Connolly & Hyndman, 2003; Hyndman & McDonnell, 2009; International Federation of Accountants, 2008; Jayasinghe & Soobaroyen, 2009; Keating & Frumkin, 2003)
<i>Fiscal</i> is concerned with whether the funds were spent as stated.	(Cordery & Baskerville, 2005; Dellaportas et al., 2008)
<i>Hierarchical</i> focuses on those stakeholders who control access to key resources, such as funders.	(Agyemang et al., 2009; Lindkvist & Llewellyn, 2003; O'Dwyer & Unerman, 2008)
<i>Holistic</i> encompasses the broader range of accountabilities.	(Agyemang et al., 2009; Ahmed & Wickramasinghe, 2009; Cordery, 2008; O'Dwyer & Unerman, 2008)
<i>Identity / Individual</i> focuses on integrity which is integral to organisations and individuals.	(Ahmed & Wickramasinghe, 2009; Jayasinghe & Soobaroyen, 2009; Lindkvist & Llewellyn, 2003)
<i>Managerial</i> refers to managerial effectiveness and efficiency and incorporates programme and performance accountability.	(Connolly & Dhanani, 2009; Flack & Ryan, 2004; Narayan, 2006)
<i>Negotiated</i> is where different forms of accountability are negotiated with each stakeholder.	(Ahmed & Wickramasinghe, 2009; Flack & Ryan, 2004)
<i>Performance</i> is concerned with whether goals i.e. outputs and outcomes have been achieved.	(Ahmed & Wickramasinghe, 2009; Connolly & Hyndman, 2003; Hyndman & McDonnell, 2009; O'Dwyer & Unerman, 2008; Stewart, 1984)
<i>Personal</i> refers to ethical standards and morality which can overlap with professional accountability.	(Flack & Ryan, 2004; Messner, 2009; Narayan, 2006)
<i>Political</i> is where public servants are accountable to parliament and thus the public.	(Flack & Ryan, 2004; Narayan, 2006)
<i>Process</i> is concerned with whether the procedures used are adequate.	(Cordery & Baskerville, 2005; Steccolini, 2004; Stewart, 1984)
<i>Professional</i> where professionals e.g. accountants have a duty to adhere to the standards of their profession e.g. accounting standards.	(Flack & Ryan, 2004; Narayan, 2006)

<i>Programme</i> refers to a meeting of objectives i.e. outcomes relating to an activity.	(Cordery & Baskerville, 2005; Dellaportas et al., 2008; Flack & Ryan, 2004; Stewart, 1984)
<i>Public</i> is where there is a direct accountability relationship between public servants and the public.	(Flack & Ryan, 2004; Narayan, 2006)
<i>Social</i> is the impact the charity has on other organisations, individuals and the environment.	(Ahmed & Wickramasinghe, 2009; Jayasinghe & Soobaroyen, 2009; Lindkvist & Llewellyn, 2003)
<i>Upward</i> to financial supporters and oversight bodies.	(Adams, 2004; Agyemang et al., 2009; Ahmed & Wickramasinghe, 2009; Association of Chartered Certified Accountants, 2006; Connolly & Dhanani, 2009; Cordery, 2008; Dhanani, 2009; Jayasinghe & Soobaroyen, 2009; O'Dwyer & Unerman, 2008)

Table 5-4 Concepts of Accountability

For this research the distinction is not between standards and judgement, but rather between financial and performance accountability, which together incorporate several other concepts of accountability as can be seen from *Table 5-5*.

<i>Financial Accountability (Findings Chapter Six & Seven)</i>	<i>Performance Accountability (Findings Chapter Eight)</i>
Financial accountability encompasses a wide range of concepts including: compliance; control; fiduciary; fiscal; process; professional; and probity.	Performance accountability also incorporates: managerial and programme

Table 5-5 Aspects of Charity Accountability

This research also draws on the theoretical constructs of hierarchical and holistic accountability highlighted by O'Dwyer & Unerman (2008) and has already looked at accountability in relation to stakeholders (*Chapter Five, section 5.3*), which implicitly relates to the following concepts of accountability: downward; negotiated; political; public and upward. Implicit in this research is also the assumption that individuals act ethically, which incorporates the concepts of individual and personal accountability. Another category drawn on throughout this research is social accountability, which considers the impacts charity has on its environment, including its stakeholders.

As shown in *Table 5-5* the focus on reporting findings for this research will first be on financial accountability, in particular professional accountability as reflected in the production of financial statements compliant with appropriate GAAP, covered in *Chapter Six*. Fiduciary accountability is covered in relation to compliance with legislation and the need for monitoring, which is covered in *Chapter Seven*. Second, performance accountability, which is associated with the efficiency and effectiveness of

charities, will be covered in *Chapter Eight*. However, before looking at financial accountability the limitations and disadvantages of accountability will be considered.

5.7 Limitations of Accountability

Whilst accountability has many followers there are also some conceptual limits to accountability that need to be considered. Messner (2009, p. 932) wrote about limits of accountability and highlighted:

One's opacity to oneself, which implies that the accountable self cannot fully recall the situations in which she has been involved and she cannot fully justify her decisions and judgments.

Aligned with this is the concern that accountability and the need to discharge it will become so dominant that concern for the underlying cause of the charity will be moved to the back burner, as time is spent ensuring accountability is discharged appropriately. As Messner (2009, p. 929) further highlights:

It is certainly true that being forced to account in a particular way creates an additional burden.

Another practical limitation of accountability is the concern about how much information to release in order to discharge accountability. This was seen in a study by Parker (2003) of a large religious based community welfare organisation whose Board experienced a tension between expanding accountability to the fullest level of disclosure and the widest range of stakeholders, and between limiting disclosure format and stakeholder range in order to preserve maximum donor financial support.

5.8 Summary

This chapter has discussed the concepts of accountability that underpin this study. In doing so there was a need for a robust definition of accountability to be adopted for this study, given the myriad of definitions of accountability. Rather than constructing a new definition Fishman's (2007, p. 13) definition of accountability is adopted as it emphasises the link between charitable purpose and the need to account for it:

The process by which assets devoted to charitable purpose are put to their proper purpose and information about their use is made available to [stakeholders].

This research aims to understand the drivers and motivations behind the reasons 'why' charities act as they do. Of particular interest in this research is which particular accounting methods charities use in relation to the four complexities of charities' financial statements identified in *Chapter Three* i.e.: choosing the accounting basis;

recording property, plant and equipment; recording funds; and accounting for expenditure overheads ratio.

Accountability should be at the heart of ‘why’ charitable organisations are acting as they do. Thus accountability is the theoretical lens through which interviewees’ actions will be clarified. For as Messner (2009, p. 919) says:

Sometimes the reasons why somebody has taken a particular course of action are not entirely clear to the person herself.

It will be up to this study to identify the reasons for charities’ actions through the lens of three different concepts of accountability. First, the importance of financial accountability, in particular professional accountability as reflected in the production of GAAP compliant financial statements, will be covered in *Chapter Six*. Also in relation to fiduciary accountability in relation to compliance with legislation and the need for monitoring will be covered in *Chapter Seven*. Contrasting financial accountability is performance accountability, which is associated with efficiency and effectiveness; will be covered in *Chapter Eight*.

CHAPTER 6: PROFESSIONAL ACCOUNTABILITY

Please note the roles of interviewees as summarised in Table 4.5 will be reflected in brackets at the end of relevant quotes by the following key: M = Manager; T = Treasurer; B = Board member; E = Charities sector expert; and A = NZICA member.

6.1 Introduction

The focus in these three findings chapters will firstly be on financial accountability as reflected in the production of financial statements compliant with appropriate GAAP and legislation, before finishing the findings chapters by looking at performance accountability in *Chapter Eight (Figure 6-1)*.

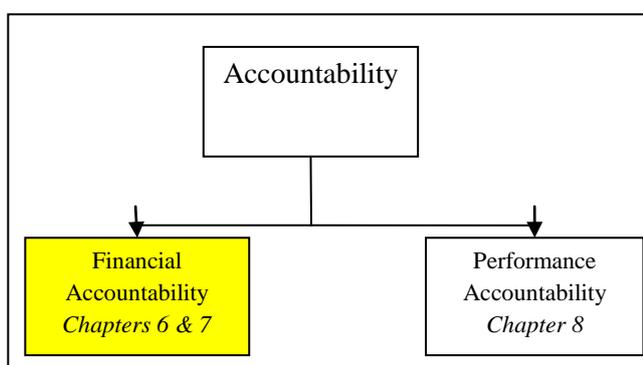


Figure 6-1 Dimensions of Accountability

Financial accountability encompasses a wide range of categories including: compliance; control; fiduciary; fiscal; process; professional; and probity (Connolly & Dhanani, 2009; Connolly & Hyndman, 2003; Hyndman & McDonnell, 2009; International Federation of Accountants, 2008; Jayasinghe & Soobaroyen, 2009; Keating & Frumkin, 2003). However, when focusing on compliance with GAAP and legislation, the sub-categories of professional accountability and fiduciary accountability become the focus. Compliance with GAAP, i.e. professional accountability will be covered in this chapter. Compliance with legislation, i.e. fiduciary accountability, will be covered in *Chapter Seven (Figure 6-2)*.

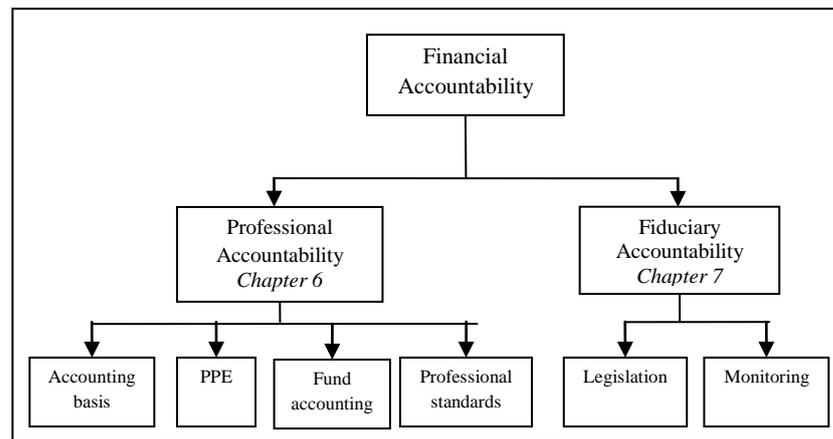


Figure 6-2 Dimensions of Financial Accountability

England and Wales' Charity Commission considers that easy access to accurate and relevant information about organisations in charities is essential for real accountability and for trust and confidence in the charitable sector (Charity Commission, 2004). However, at times charities must question the need to prepare financial statements, as too few of their stakeholders request them or, as one charity manager states:

You could put up complete acts of fiction as the financial accounts for the year and the membership wouldn't even notice (O'Dwyer & Unerman, 2008, p. 813).

However, this 'unquestioning trust' (O'Dwyer & Unerman, 2008) places an additional burden on charities to ensure their financial statements are transparent. Roberts (2009, p. 957) looks at transparency as a mechanism of accountability "to cast light upon what would otherwise remain obscure or invisible" or as he (Roberts, 2009, p. 958) further states:

Transparency promises and threatens to reveal or discover the self as good or bad, clothed or naked, beautiful or ugly.

GAAP-compliant financial statements are seen as an aid to ensuring transparency. As detailed in *Chapter Two*, New Zealand currently operates under a sector neutral basis and has two forms of GAAP based on the size of an organisation. First, for large organisations there is the need to comply with IFRSs in the form of the 'Not for Profit Financial Reporting Guide' (New Zealand Institute of Chartered Accountants, 2007a). Secondly, SMEs may comply with 'old' GAAP as outlined in the 'R120 Financial Reporting by Voluntary Sector Entities' (New Zealand Institute of Chartered Accountants, 1999). SMEs may also comply with IFRSs if they desire.

However, these standards are not widely recognised or utilised in New Zealand, unlike England and Wales where there is broad acceptance of the importance of the SORP as a vehicle for GAAP (Connolly et al., 2009). This fact led one interviewee in this research to bemoan the lack of appropriate standards:

What is clear is the poor quality of some of the financial statements which highlights the need for appropriate reporting and audit standards. (Interviewee 2 M/A)

Unfortunately, there is no requirement to prepare compliant GAAP financial statements unless the preparer or auditor is a member of the NZICA. This reflects Connolly, Hyndman & McMahon's (2009, p. 17) study, where one of the participants states that "If too lax a framework [exists, charities] won't bother". This was noted by one interviewee of this study:

We're just telling people they have to be IFRS compliant, but we don't really believe that they will be (Interviewee 3 T/A)

This section introduced professional accountability and how this will be assessed in this chapter. It also detailed the GAAP that will be considered when looking at the three complexities in charities' financial statements. Next, we will look at the accounting treatment within the financial statements for three issues with transparency and understandability identified in *Chapter Three*: the accounting basis; recording of property, plant and equipment; and fund accounting.

6.2 Accounting basis

Chapter Three identified that to comply with both sets of GAAP, charities will need to operate under an accrual basis, apart from pledges and donations which are recorded when they are received. Two issues were identified in the literature regarding the accounting basis: certainty of receipt and whether accrual accounting, in particular the matching concept, is suitable for charities. First, the accounting bases used by charities in the study will be determined.

6.2.1 Accounting basis used

This research found that charities predominantly operated under a cash-basis as highlighted by the following two interviewees:

We recorded items when we got them (Interviewee 3 T/A)

I only record what actually comes in. (Interviewee 23 T)

The reason for operating under the cash basis was because of its simplicity, as noted by the following interviewees:

It is recorded once it [an expense or revenue] comes through the cheque book. It is much simpler to do cash based accounting, and this also opens up the range of Treasurers you could have, [i.e. that can do cash accounting as opposed to accrual accounting] because it's [cash accounting] a lot more straightforward. (Interviewee 7 T)

Because the [charity's] finances are cash based ... we don't use accruals. They [Board members] tend to measure wealth as what's left in the bank. (Interviewee 6 T/B/A)

However, as well as differing from appropriate GAAP, several interviewees considered that accounts were meaningless under a cash basis as illustrated by the following quotation:

We use the financial reporting guide. You just cannot produce a meaningful set of accounts when you've got NZD80,000 worth of loans that you're obligated to pay to somebody else, and it's not recorded anywhere in the accounts. (Interviewee 11 T/B/A)

The need for the accrual accounting basis is supported by Connolly, Hyndman & McMahon's (2009, p. 18) study, which found that funders were of the opinion that financial statements prepared under an accrual basis were just "*better accounts*" regardless of the size of the charity. This emphasis on the accrual basis is also recognised in the recent review of financial reporting in New Zealand where the suggestion is for charities to prepare accrual accounts if their operating expenditure is greater than NZD20,000 (Accounting Standards Review Board, 2009).

6.2.2 Certainty of receipts

For those interviewees that prepared financial statements under an accrual basis, the consideration of 'certainty of receipts' was a key concern, particularly the issue of pledges and bequests, and when best to record them in the financial statements. This focus on certainty was illustrated by the following quotations:

I mean there's someone who says they're going to put \$5 in the plate [collection box in the church] every week and, you know, there's no way that you would accrue that, because there's no certainty. So it does come down to that certainty, because you couldn't hold someone to a pledge to put money in the plate. (Interviewee 3 T/A)

A pledge is a pledge, it's a promise, you know. Accounting has to be real. And people can promise, but at the end of the day they might not deliver. (Interviewee 4 B/A)

I guess there are two accounting dimensions to that [receiving donations on a regular basis]. One is the commitment that they make, and that's a relatively loose commitment. There clearly would be no basis for us to recognise any revenue, and it's just basically filling in a form and saying I'll do it. But we have no basis to go back to them, and we have never ever gone back to anyone and said, "You said you would and you haven't". There is a moral obligation but no, nothing that would meet the definition of recognition in terms of a liability. (Interviewee 11 T/B/A)

This issue of certainty is seen in the media where appeals for monies end up with only a limited amount received from that pledged and can be seen in the following examples:

television fund-raising telethons 35% received (Henderson, 2002); Boxing Day tsunami 10% received (Radio New Zealand, 12 January 2005); and Afghanistan appeal 40% received (Anonymous, 2008d).

Another problem is the issue of when to record bequests when the charity has been named in a will. Should monies be recognised when the will is settled or in probate, or even when the person has died and the charity knows the sum that has been set aside for them? Most interviewees who practised accrual accounting tended to look at bequests on a case-by-case basis as each bequest tended to have its own particular circumstances.

People's wills, ... there is a fund that gets a certain amount every year and they could probably work out what it was going to be, but there was not ever an attempt to accrue that, so that was an ongoing thing. And when people die, the [charity head] might know that Joe Bloggs has died and left X amount of money. But no-one tells the Treasurer so how can he accrue it? (Interviewee 3 T/A)

You're recognising when you receive the cash, well obviously because until we open the envelope we don't know anything. Quite often the amounts aren't known, we're just told that we're named [in the will], we don't know the amounts so... you know the reliability of measurement is clearly not met. There's no commitment and they don't know necessarily what's going to come out of the woodwork in the estates. (Interviewee 11 T/B/A)

We have noted an increase in the bequests which are mainly from aged people with property and leaving some of their property to a charity. [Our clients] are extremely conservative when it comes to pledges. They don't want to count their chickens before they hatch which I think is actually appropriate. We've found with a number of these ones where they have been left property, or part of a property in a will the family has contested. (Interviewee 18 A)

The need to address the different circumstances of each bequest is recognised in the NFPFRG which has eight examples of different bequests (New Zealand Institute of Chartered Accountants, 2007a). The financial importance of bequests is highlighted by one interviewee who comments:

These incomplete estates [bequests] were valued at somewhere in excess of NZD20 million. So that is a resource of the [charity] that is entirely off the balance sheet. (Interviewee 5 T/B/A)

With potentially such a material sum it is important that bequests are recognised in the financial statements. The accounting treatment for the NFPFRG's eight bequests are to either recognise the bequest as an asset if receipt is certain and recognise the bequest as a contingent asset if receipt is uncertain (New Zealand Institute of Chartered Accountants, 2007a).

In relation to pledges, it was pleasing to see a cautious approach taken when considering the certainty of receipts by charities. This is at odds with the media, whose goal of

‘selling a story’ makes them focus on pledges made rather than donations received. As several interviewees reiterated, a pledge is just a promise so there is no certainty that it will be received. Next, the matching concept especially in relation to grants and donations received for a particular purpose will be examined.

6.2.3 Matching concept

Matching has its roots in the economic premise that sacrifices must generally be made (costs must generally be incurred) to achieve benefits (revenues). The International Accounting Standards Board considers that the ‘cost-revenue matching objective’ is where cost is expensed when the revenues to which the expense is considered to contribute, is recognised (International Accounting Standards Board, 2005).

Several interviewees used the matching concept to justify why all donations were not placed in revenue. In the current study interviewees who were aware of the matching concept were likely to utilise it. However, many interviewees were not aware of the concept, but after explaining to them its function and the justification for its use, many interviewees who had previously not be aware of it appeared very keen to utilise it, particularly to ‘smooth’ out their surpluses and deficits.

I was trying to provide a reconciliation between cash received and the amount that we were showing as income, and why was there a difference, because there was income that we had [pause] ah sorry, cash that we’d received, but we hadn’t earned the income yet because if we don’t do what we’re supposed to, we have to give it back. (Interviewee 13 B/A)

So, how much to apportion as income for this year and how much is apportioned for next year? If we get that wrong, it really can have a huge impact on the bottom line. And so I do spend some time at the end of each year, because they [the grants] very rarely end within one financial year. I’m calling them grants received and advanced and stuff. So that’s our biggest problem. If we aren’t aware, if we say put the whole income in this year, but we’ve still got \$30,000 worth of wages we have to pay to finish the contract, we can get ourselves into a terrible state, not having provision for the staff to do that this year, and yet we owe it on the contract. (Interviewee 15 M/B)

It took three years to work through it [the grant]. We just spread it over that period of time that it was used. You just can’t put it into that one year: it just didn’t relate to it [the year as the expense would be incurred in the next financial year] at all. (Interviewee 36 T/B/A)

For a contrasting view of the matching concept, it is interesting to note that the Charity Commission in England and Wales does not allow the matching concept in their SORP. This was highlighted in Connolly, Hyndman & McMahon’s (2009, p. 30) study where one interviewee said “*the matching principle was thrown out when the SORP came in. I want it back*”. In relation to the SOFA another interviewee states that “*recognising*

them in the SOFA in full completely distorts the annual income” (Connolly et al., 2009, p. 32). The last statement highlights the problem of not following the matching concept, which can mean by showing all the income in one year, for a three-year project, the first year the charity would have a large surplus followed by potential deficits in subsequent years.

However, their study also had proponents of the SORP not using the matching concept who considered that *“if a charity has been successful in raising funds then this needs to be shown as part of what happened in the year”* (Connolly et al., 2009, p. 30). They also found that funders who possibly were least likely to fully understand the technicalities of the matching concept, were more likely to view matching as a distorting influence (Connolly et al., 2009).

This section has highlighted the two views of the matching concept. The first consider that it is a useful tool to utilise especially with regards to projects spread over more than one financial year. However, the other view is that a charity should be proud to show the funds it has received for the year. The researcher’s view is that if funds were recorded correctly this figure could still be obtained by adding income with grants/donations received in advance, and the advantage of matching income with expenditure and clearly being able to see if the charity has raised enough funds to cover each year’s projects was important. Having looked at the two complexities regarding the accounting basis, certainty of receipt and the matching concept, issues concerning PPE are considered next.

6.3 Property, plant and equipment (PPE)

Chapter Three identified that to comply with either set of GAAP, charities will need to record the initial cost of PPE and depreciate that asset. Both GAAPs also require that PPE be valued at fair value without giving specific guidance as to how this is calculated. Three issues were identified in the literature on PPE: PPE is often not recorded; how to value ‘fair value’; and where PPE was recorded but not depreciated.

6.3.1 Recording Property, Plant and Equipment

In this study, charities that utilised the cash basis to prepare accounts did not record assets as illustrated by the following quotations:

So [pause] as far as they’re [the Board] concerned, it’s come out of the bank account, it’s gone now. And if it breaks down tomorrow, well yes, but the fact

that you can use it [the stove] for many, many years is irrelevant. (Interviewee 6 T/B/A)

[We] expense fixed assets as soon as [the Board] get them. Example –coffee maker of \$1,000 was straight away expensed. (Interviewee 7 T)

The problem that we have is people not recognising them [PPE] initially. (Interviewee 18 A)

Some interviewees tried to justify their method to their auditor as the following quotation highlights:

I had a very good debate with a chartered accountant in public practice who is also the Treasurer of a [charity]. I'm the auditor of the wider [charity]. And he basically said they don't record any assets. Everything that they buy they expense - depreciation is irrelevant to them. They're not going to sell anything, so what's the point of fair valuing it and holding it as an asset? And, you know, this is a guy who is a chartered accountant in public practice so it's very interesting. And again like you I can see some logic in what he's saying, especially in the church organisation when the primary asset of the church, the building, is more of a liability than an asset [due to maintenance etc]. (Interviewee 18 A)

However, there were also instances where charities may not have recorded PPE on their balance sheet but they kept an asset register as the following quotations illustrate:

The reason we mainly keep an asset register is because once a year, the [charity's head office] arranges insurance and they tell us what they think we should be paying for content insurance, and we are responsible to make sure that the amount we're paying on content insurance is adequate for the contents that we have. (Interviewee 7 T)

At the moment that's [the figure in the balance sheet] just the [PPE] book value, that's just basically the money spent on it. We have a separate valuation for insurance purposes, about \$460,000 [Balance Sheet Land \$59,517.33 and Building \$133,820.55] last time it was done. (Interviewee 23 T)

Interviewees who prepared their financial statements under the accrual assumption tended to capitalise PPE that they had bought for cash. However, recording was not so clear-cut when the PPE had been donated, which could lead to the financial statements not 'telling the story' of the charity:

There were assets of the entity that are clearly not in there [the balance sheet] that ought to be in there. (Interviewee 11 T/B/A)

I've never brought anything on [the financial statements] that's been donated. (Interviewee 3 T/A)

XXX donated us 20 computers. 20 of them have kept us going for 5 years, us and another organisation. And [pause] they aren't in our books anywhere. So you'd think we were operating without computers, but we absolutely categorically could not operate without computers. (Interviewee 15 M/B)

When you're doing asset sighting it's like "well where did this photocopier come from?" Oh, oh, that's not in the books because that was given to us.

(Interviewee 18 A)

Several interviewees attempted to justify the lack of recording of donated assets, as can be seen in the following quotations:

I haven't recorded the donated ones because most of them were all quite minor donations. (Interviewee 23 T)

But in fact we would always acknowledge those donations [pause] within the end of year accounts with the list [many charities attach a 'thank-you' list to their financial statement which lists who and what, or how much, people have donated]. (Interviewee 36 T/B/A)

In New Zealand the lack of recording donated PPE has been highlighted in the media:

Now donated goods aren't included as part of the accounts of the organisation, and sometimes there's a false impression that might be given. (Radio New Zealand, 27 August 2009)

Contrary to this view were other interviewees who consider it is important to ensure the financial statements reflect the assets of the organisation:

I think there is a need for people to clearly communicate what's not costed and in the accounts if they can. (Interviewee 18 A)

So we take it in as an asset, it goes into [the interviewee's charity's] books. It scares me when they [other charities] don't [record the donated asset]. XXX used to donate XXX a year. It meant that we didn't expend, but initially they weren't taking it as an income, but it's an asset. I mean, it comes in. We expend on that because XXX expects to get hospitality packages and things like that. So you've got to have an in and an out. (Interviewee 29 M/B)

Whilst most charities tended to comply with GAAP regarding PPE that they purchased, this was not true with regards to PPE that were donated. There were two views regarding this, the first complied with GAAP and considered that the financial statements should reflect reality, i.e. all PPE recorded, whether bought or donated. The second did not want to look 'rich' by having too many assets. GAAP does not distinguish between how PPE were acquired, i.e. either bought or donated, but focuses on all material PPE needing to be recorded appropriately, which with donated PPE is by fair value, which will be considered next.

6.3.2 Fair value

Fair value is defined as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction (Gillingham & Yeoh, 2007). PPE should be valued at fair value. With limited specific guidance as to what constitutes fair value charities have come up with their own determination of what constitutes fair value for donated PPE noted by:

We've taken a fairly simplistic approach of donated fixed assets - of what would

the organisation pay to have those in terms of the valuation. And we try and suggest that the clients engage with the donor regarding the value. Otherwise it's what would it take the organisation to buy an asset of a similar type and condition. (Interviewee 18 A)

There is also a need to ensure fair value is calculated for all PPE, which can be fraught with difficulties as illustrated by:

The concept of 'fair value' requires a great deal of interpretation and explanation for NFP's. Frequently the judgements are not made by 'professional valuers' as suggested in the ED [i.e. appropriate GAAP], but by volunteers in various capacities and of varying competence and ability. (Interviewee 5 T/B/A)

This lack of expertise can be seen by the next interviewee who just relied on the Rateable value (QV) done by local councils rather than a registered valuation:

We go through a checking process to make sure that on the major assets, we do get the most current valuations. For the property, we go by the latest QVs. (Interviewee 6 T/B/A)

Some interviewees question the need to fair value PPE whilst other interviewees bemoan the effort it takes to fair value their PPE, as highlighted by:

They [the properties] were not valued they were just taken at cost, because there's no tax implication, so they [the charity] didn't bother with revaluing it, as it costs money. (Interviewee 4 B/A)

A major entity may have 200 or 300 or more estates where the testator has died, but the assets have not been realised. Every one of those estates would need to be valued for each balance date of the entity, with professional judgements being exercised about the fair value of the assets of the estate, and consequential movements reported in the income account of the [charity]. They may be significant, measuring millions of dollars in some cases, and providing useful information about sustainability and so on. But the effort required to meet this proposed standard should be recognised and minimised if possible. (Interviewee 5 T/B/A)

Perhaps indicating the high-level of non-compliance in valuing PPE according to fair value is seen by Trevor Garrett, the Chief Executive Officer of the Charities Commission, comment on national radio that:

Donated goods aren't included as part of the accounts of the organisation, and sometimes there's a false impression that might be given. And so charities now are going to have to start thinking about how can we tell the full story about us as an organisation? [emphasis added] And that will help them get through what might be, you know, a difficult period with this new age of transparency (Radio New Zealand, 27 August 2009).

With two views of donated PPE, record or do not record, valuing donated PPE is always going to be contentious for those that do not record their donated PPE. For charities willing to record donated PPE at fair value, the issue becomes how to do it. With limited guidance from GAAP the methods of valuing varied considerably. Until, GAAP

provides specific guidance on how to determine fair value on different types of PPE this situation will remain unchanged. Another aspect of recording PPE is depreciation, which will be considered next.

6.3.3 Depreciation

Those charities that do manage to record their PPE then need to depreciate those PPE if appropriate. Charities appeared to take their depreciation rates from those detailed on the Inland Revenue Department's web site which infuriated one interviewee:

What we have ended up doing with some clients is having quite a debate about what's the appropriate rate of depreciation because people just take the Inland Revenue Department rates as gospel. And what we say to them is well hang on, let's look at this in context of your organisation. How long is a computer going to last in your organisation versus the average company which is trying to write that off over the fastest period. (Interviewee 18 A)

The above interviewee's client appears to have a lack of understanding of what depreciation is. This lack of understanding can also be observed in the comments of several other interviewees who consider that depreciation is a capital replacement reserve rather than the operational cost of using the PPE, i.e. the 'wear and tear' of the PPE and the writing off of PPE over its useful life, highlighted by:

That is a very interesting thing, the way they depreciate the assets, not the way you think of it, it's more like a provision for replacement. They work out how much it's going to cost them to replace, and then that becomes their depreciation. We look at that in this way, replacement. But we disguise it as a provision for depreciation. (Interviewee 4 B/A)

We can't guarantee someone is going to give us a free one in the future, so we should be somehow keeping track of [the donated asset] as what are we going to do when this life dies. That was the part of it that really got me. [i.e. not putting money aside for replacing the PPE – completely missing the point of depreciation] (Interviewee 15 M/B)

This confusion between a charge for 'wear and tear' or writing off of its value over its useful life and 'replacement reserve' was highlighted by CPA Australia (2000 Chapter 5, page 5) who consider the issue was whether the ongoing costs of operating the PPE was important or "is the cost of the depreciable asset crucial only when replacement is required?". This was also seen in a study by Simpkins (2006b, p. 71) whose research participants raised "concerns that depreciation charges can frequently bear no relationship to future capital needs".

GAAP considers that the way in which a PPE is acquired should not influence the accounting treatment. However, it does seem unreasonable to expect donations from

contributors twice - first to fund PPE and second to cover the depreciation of the PPE - so perhaps there is an argument for not depreciating donated PPEs.

This section considered the three complexities in charities' financial statements relating to PPE: when to record, how to fair value and how to depreciate. Next, the complexities relating to fund accounting will be considered.

6.4 Fund accounting

The issue of fund accounting in charities is highlighted by the following quotations:

Tagged [restricted] funds are a pain in the butt but you can't get away from them. (Interviewee 14 M/A)

At one point there would have been one hundred and twenty individual funds at the [charity]. (Interviewee 5 T/B/A)

Issues identified in *Chapter Three* from the literature on fund accounting were: the need to have specific definitions of relevant words such as funds, reserves and restricted; whether there was consistency when recording funds; and why different funds were excluded from the charities' financial statements.

6.4.1 Type and Purpose of funds

As seen in the following quotations, several interviewees have attempted to gain an understanding of the large number of funds in their particular charity and whether they are 'freely available'. In doing so there was a need to determine which funds were valid, i.e. restricted by the donors, and which were set up at the charity's discretion to separate out particular monies into a reserve or designated fund - a practice which appears particularly prevalent in several charitable organisations as illustrated by the following quotations:

So they [the charity] had funds like that that were just buckets. They [charity's Board] put their legal hat on and said well if there's legal impediment then it should be in a fund, but otherwise not. (Interviewee 3 T/A),

They were just partitions. So, they were nothing. And someone had just decided some time in history to make a separate box for them. We got rid of the ones that made no sense, those that resulted in clear obligations to other parties we simply accounted for them consistent with those obligations. We've had advice, [the funds] wouldn't create any legal obligation limiting the way we spend the money, but we are absolutely determined that we never would spend the money other than for that purpose [laid down by the donor]. (Interviewee 11 T/B/A)

The study in England and Wales by Connolly et al. (2009) also highlighted the issue of charities separating out monies into a reserve or designated funds. The participants in their study considered that information on reserves is important to charities' financial

stories. However, this was only meaningful if properly applied, and not abused by charities to hide the true level of unrestricted funds, as details of free reserves were particularly important for stakeholders in making their decisions as to whether to fund particular charities.

However, a problem was identified in this research with regards to restricted funds, where donors had explicitly placed restrictions on how the monies were to be used but did not follow-up that this had happened, as illustrated by a quotation from:

Tagged grants are in my view two parties' responsibility. One is the donor, one is the donee. And what we find is that the donors are often very poor at following up, or even show a general disinterest. We had one client recently involved in a fraud case where it came to light that the funding was given for a specific social purpose, and was not being used for that purpose. (Interviewee 18 A)

One interviewee also highlights the problem with the lack of specific definitions for different funds in the Charities Commission (2008c) Annual Return which splits equity into three (general accumulated funds; restricted purpose funds; and endowment funds), but does not allow room for reserves.

Also, the Charities Commission currently provides no explicit definition of what should be included in each of these three equity categories. Further, this research has exposed a lack of basic understanding by charities of whether their funds are restricted in any way, meaning that the figures being derived from the Annual Returns cannot be relied upon to gain an understanding of the level of restricted and endowment funds in New Zealand charities.

6.4.2 Recording of funds

In *Chapter Three* GAAP for SMEs states that equity could be split between restricted and unrestricted, but no such suggestion is promulgated in GAAP for large organisations. However, both GAAPs require disclosure on restrictions on cash and PPE but make no specific mention of the need to disclose restrictions on funds. However, the recent release of ED118 by the Australian Accounting Standards Board, & New Zealand's Financial Accounting Standards Board is more explicit about the need to disclose on the face of the financial statements, or in the notes, any income, assets or liabilities that are subject to restrictions (Australian Accounting Standards Board & Financial Accounting Standards Board, 2009) .

There is a need to record restricted funds separately, to enable a complete picture of how much of accumulated funds were restricted, to gain an appreciation of the financial stability of the charity, a matter which will be discussed further in *Chapter Eight*. Some interviewees showed the split between restricted and unrestricted on the face of the financial statements:

What it's [separating out restricted funds] trying to show is that the Board doesn't have unfettered control over equity. There are parts of it; it has control over - accumulated fund. So when it came to what was its discretion, its discretion was on NZD109,000. So despite the fact that equity is NZD517,000, discretion was only actually over a small portion of that. (Interviewee 13 B/A)

That tag [restriction] stayed on the donations until the money was spent. They went into a restricted fund. And then at the end of the year the amount that had been spent on the [activity] was taken from that restricted fund. The income was shown as in the income account and of course that meant that there had to be a transfer of funds at the end so that the total deficit or surplus was split up across various funds. (Interviewee 5 T/B/A)

It [restricted monies] will be taken as income, and immediately taken out to the balance sheet because it's not our funds. Once it's in the balance sheet, we'll be showing it as a liability. (Interviewee 9 M/B)

Other interviewees showed the split in the notes to the financial statements:

They would have them in the notes, basically. And movement in and out of the funds would be shown on the income and expenditure statement. (Interviewee 3 T/A)

However, charities that separated their restricted funds were in the minority, as can be seen from the following quotations:

It [restricted fund] goes into the general fund; it doesn't go into a special account or anything. (Interviewee 28 M/B)

They [the charity] had it [restricted funds] in the balance sheet, and it's totally hidden from...you know, they don't show it to the [main stakeholders]. Before, it was straight into the reserve or not even the reserve, call it like a liability account in the balance sheet, and all the debits and the credits go straight into there, and you can't trace that at all. So people were not aware of the existence of fund accounts. (Interviewee 4 B/A)

Not separating out restricted funds can give an unclear representation of the financial viability of a charity, as can be seen from the following quotations:

I can tell that all the money in that bank account is pledged funds. So they were actually using tagged funds for general operating. (Interviewee 14 M/A)

We're either very financial or considerably in deficit. Twelve month contracts do not coincide with our financial year so we've been paid out for a portion of the 6 months that we've not yet earned. (Interviewee 21 M/T)

Some charities were in the process of separating out the restricted funds to ensure transparency, particularly with funders:

I want more transparency. I want it to be shown in the Profit & Loss or the Income Statements, so that people can actually see that this is the income, this is various categories of income, OK, and where this is tagged to, and then how it's being used, and what's the left over, yes. (Interviewee 4 B/A)

So you've got your general [fund] that's not tagged for any old thing, and then all the other bits [restricted funds]... And there's a chance that your uninformed reader might actually understand it [separating out restricted from unrestricted]. It's a bit more extra effort, [pause] and yet to my mind it's the most logical presentation there is, so why do we not do it, Because it's too much effort. When you go to all these funding bodies they say well how much money have you got in the bank? Now, unless you can convince them that actually that money in the bank can't be spent - You're stuffed. (Interviewee 14 M/A)

Other accountants had managed to separate out funds but were then beset with problems relating to the lack of understanding of fund accounting reflected by the following interviewee who was an auditor of numerous charities

We've had good successes getting people to treat it [restricted funds] appropriately in their balance sheet but the problem is that often times it will just disappear from the balance sheet. Sometimes there'll be some restricted amount and what we always try to do is to get our clients to clearly state that [the restricted amount] via note. You try and convince them to do that [show in notes] by virtue of the fact that it's a great way for them to thank the donors by highlighting it that way. (Interviewee 18 A)

Contrary to the above auditor, other charities found auditors were not supportive of restrictions being separately shown

Statement of uncommitted funds – some auditors accept some don't: why? [They] can't see a problem with showing additional information. [The charity] has a statement in notes. [Other] auditors, despite numerous discussions, were not happy to include the statement. (Interviewee 45 B/A)

With regards to recording of funds, in particular, splitting them between restricted and unrestricted, being able to see what was 'freely available' aided several charities in their assessment of financial viability. The issue of whether charities are financially viable will be further considered in *Chapter Eight*. However, some charities, rather than including funds in their own financial statements, recorded them into separate legal entities, which will be examined next.

6.4.3 Separate entities

The final issue with fund accounting goes beyond how to record funds to the consideration of the reporting entity and, where separate funds are recorded, which funds should be consolidated into the charities' group financial statements.

The concept of control is the basis for determining which funds should be included in group financial statements (International Accounting Standards Board, 2008d). A

charity will have control of a second charity, or fund, if it has the ability to gain economic benefits from its activities (International Accounting Standards Board, 2008a). The problem the definition of control raises in charities is that the concept of ‘returns’ is inappropriate for charities (*Chapter Three*).

There were several proponents of consolidation amongst the interviewees:

At our AGM, we present the consolidated accounts. (Interviewee 28 M/B)

The reason why I’m still of the view that it [the charity] needs to produce consolidated accounts is that those total resources are actually at the disposal of the [charity]. The control is by the appointment of the trustees. (Interviewee 5 T/B/A)

In the past our accounts didn’t even have some of these [separate funds] in the primary accounts. That wasn’t really acceptable because you couldn’t get a sense of the overall scale of the organisation. (Interviewee 11 T/B/A)

Again, charities that consolidated funds were in the minority and interviewees highlighted that it was common practice for charities to set up separate entities that were not consolidated. The main reason appears to be to ensure the charity does not look ‘rich’ in either their assets or income:

I presented my IFRS accounts to the XXX. And they decided not to consolidate ... This is a quarter million dollar business. (Interviewee 3 T/A)

To appear ‘poor’ a common practice was to incorporate a charity as an incorporated society which ‘ran’ the charity and set up a separate charitable trust to keep surpluses and assets.

Several subsidiary trusts were used to hide capital. (Interviewee 1 A)

The Endowment Trust was born of the devil. It was actually an attempt made to remove \$5 million from the control of the [charity] which we managed to get back. (Interviewee 28 M/B)

We went bankrupt, about 20 years ago. So to avoid this happening again, we’ve set up a Trust, which holds the assets and then we have the charitable society itself which runs the organisation. We will maintain surpluses in [the society’s] reserves, or we will transfer them to the Trust. That’s been done in my time, actually fed money into them [the trust rather than the charity]. (Interviewee 8 B)

It actually has a Trust as well which you don’t see in those accounts there. If you’ve got too much money they [the funders] tend to turn you down. If however you’ve got a Trust, you can sit some of your funds across there and you can apply for funding with legally not showing the full amount of funding that you have available to you. (Interviewee 29 M/B)

Previously, with separate registers for incorporated societies and charitable trusts, the link between the two charities was not obvious. However, this is no longer the case when both entities are in the Charities Register, so lack of consolidation of entities over which a charity has control is more apparent:

It is also possible to see [on the Charities Register] which organisations have 'foundations' alongside them although it is not always clear why they are not consolidated. (Interviewee 2 M/A)

However, a more cynical interviewee suggested that charities would obscure this link by changing the charitable trust name:

They'll rename them [charitable trusts] with totally different names that aren't related to the original [charity] name [pause] and the only way that you might track that actually going down is by doing searches to find a commonality of directors. (Interviewee 12 M/A)

Another suggested reason for not consolidating relates to the lack of available information on the separate fund as people were 'empire building' and keeping information to themselves:

All those people who are managing those [funds] are control freaks they haven't shown us [Charity's Board] a pure set of accounts at all. And rightly speaking, they should be incorporated with the main set of accounts. But right now it's not. (Interviewee 4 B/A)

Other interviewees considered that the cost of consolidation outweighed the benefit of consolidation:

I had to acknowledge that the costs of doing so [consolidating] were far outweighed in any benefit. However, it ought to be possible for the [charity] to understand its entire financial structure. What its assets were and how those assets could be used to achieve the mission of the [charity]. But I was never able to get that far because I think in a sense there were two things that prevented it. The first was that there were too many groups that were afraid that that would result in their losing some control over their little kingdoms, little kingdoms being \$100 million in places, you know. And the second was that the [charity] itself didn't have a clear enough vision or strategy that would enable it to make the maximum use of its resources. The benefit that I saw [with consolidated accounts] was that the [charity] could then make strategic decisions and it could use its resources in the most effective places and ways. I never managed to sell the vision and everybody else was too committed to their own continuing activity anyway. (Interviewee 5 T/B/A)

Interestingly one charity didn't include their separate entity because they forgot to do so:

I forgot to include them!! Because they are managed separately, even though legally part of the [charity]. In fact, we are currently looking at creating a separate legal entity for the XXX for this very reason. (Interviewee 20 B)

The above quotation highlights the lack of understanding of the legal perspective, where the separate funds are not viewed together as they are separate legal entities, which is not always the same as an accounting perspective. There appears to be a lack of understanding of the accounting definition of control, perhaps due to the limited number

of accountants involved in Charities' Boards compared with the number of lawyers, as illustrated by the following quotations:

So the lawyers would say, well the legal entity is X, and if you're not a part of our legal entity, we don't have to consolidate. (Interviewee 3 T/A)

The [funders] told us we had to do a XXX report collectively. And we hit the roof, as we went to somebody and the price was going to be like \$10,000. And part of the reason was [pause] XXX has a financial year from April to March, the others are January to December. We all have different ways of grouping grants and labelling things. But the bottom line is we are all legally independent entities. So the fact that collectively we look financially viable has got nothing to do with anything. (Interviewee 20 B)

Charities that consolidated funds were in the minority. There appears to be three reasons for not consolidating. The first was to ensure the charity does not look 'rich' in either their assets or income. Second, the lack of available information on the separate fund meant that a charity was unable to consolidate. Thirdly, the lack of understanding of the accounting perspective of consolidation around its notion of control, compared with the fact that they are separate legal entities and thus not 'part' of a charity.

The three previous sections have identified several reasons behind why accounting methods are used in particular circumstances. However, there are some consistent key reasons for charity's actions in choosing particular accounting methods, as discussed in the next section.

6.5 Key reasons why methods used

What particular method of accounting charities utilise has been covered in the previous sections. However, of particular interest to this research is not only what methods are used but why those methods were used. Jetty and Beattie's (2009) study highlighted the drivers and motivations for charity disclosure. However, their study suggested that the reasons were similar to those observed in the corporate literature (Jetty & Beattie, 2009). This study did not support this finding and the three key reasons for the choice of accounting methods appear unique to the charities sector.

This study found three key reasons behind the choices charities make in their GAAP: (1) poor professional standards shown by accountants who work in the charities sector; (2) a lack of understanding by charities of their financial statements; and (3) a need for charities to look 'poor' so as to attract funds. These will each be addressed next.

6.5.1 Professional standards

NZICA members must comply with their Code of Ethics (New Zealand Institute of Chartered Accountants, 2003a) in particular Rule 11 paragraph 102 which states:

Members who are involved in, or have responsibility for, the preparation or presentation of general purpose financial statements should take all reasonable steps within their power to ensure that generally accepted accounting practice is complied with.

Hence, it is a requirement that NZICA members involved in the preparation of the financial statements of charities must take all reasonable steps to ensure GAAP is followed. However, the reality is that the majority of charities' financial statements do not comply with GAAP (Simpkins, 2004). Even though charities may sometimes have limited resources to prepare accounts this does not provide sufficient justification for NZICA members to observe lesser standards of professional performance (Moore & Kelly, 2006).

This study found several instances where accountants did not keep current with GAAP and relied on their numerous years experience rather than utilising current accounting principles which were illustrated by the following interviewees:

We had a Finance Manager for 27 years who was a CA. Very competent and very methodical, but keeping up to date with the profession wasn't top of his priorities. And I suspect if you went back and looked at probably any organisation 20-27 years ago, they would have assets and liabilities that weren't recorded, and revenues and expenses that were not recorded. So it's probably only in the '90s, early '90s when sort of the mood changed that everything should be in [the financial statements]. (Interviewee 11 T/B/A)

I said because you haven't revalued your land and buildings. And they said we don't intend to. And it's the policy of the national Treasurer not to revalue land and buildings in their national accounts because they'll look too rich. And I was [pause] this guy is a chartered accountant. I was absolutely staggered. (Interviewee 12 M/A)

And I thought it [donated asset] should be in our books. And, the accountant just said no, there's no cash transaction here. (Interviewee 15 M/B)

This lack of compliance with GAAP has gained national attention through the media which have exposed charities who have not been valuing donated goods and services in their financial statements as seen by the following:

There's a huge amount of extra value that we don't have to pay for that's not receipted in our accounts, because that is all donated and we don't show that. (Television New Zealand, 12 August 2009)

There were other instances where accountants 'hid' behind terminology so as to obscure charities' financial statements, thereby limiting stakeholders' effective use of them in

their decision making. One auditor would not give a clean audit report until donations were moved into the balance sheet and labelled 'unconditional gifts'. The same auditor changed the statement of accounting policies to have the charity as a company, even though it was a charitable trust. Other interviewees uncovered similar instances:

I would ask questions of the accountant and he would give me an explanation I couldn't understand. (Interviewee 8 B)

We were told not to use the balance sheet anymore; it's a statement of financial resources now. (Interviewee 16 M/T/B)

This is the interesting thing, but because it [donations] has no GST part, we can't put it into sales and income, because sales and income generates GST. All of these funds [donations] here that we've been given we can't use for anything else. ... I had to explain to [the funder] look, we haven't made a loss, it's just that the income GST money, and the donations and unconditional gifts, are on different pages [i.e. income shown over two statements – income statement and balance sheet]. I said that's all I can tell you, they're just on different pages for GST purposes. (Interviewee 16 M/T/B)

Having been a member of NZICA for 24 years, and priding myself on being a chartered accountant, during the course of this study the researcher found it frustrating and embarrassing to observe many instances of poor quality financial statements prepared by so-called qualified accountants. These resulted in meaningless financial statements that did not tell the story of the charity and appear to indicate that the accountant did not understand the charities sector sufficiently, as shown in the following quotations:

The record keeping was absolutely meticulous. But if anybody said, last month, did we make a surplus or a loss; there was absolutely nothing that indicated that. I suppose because I knew that the record keeping was very good, I assumed that the rest of it was too. I found being able to report to [the Charity's Board] and tell them something meaningful was quite hard. (Interviewee 7 T)

The accountant they work with, he doesn't want the accounts presented in the way that actually is most useful for [the charity]. (Interviewee 15 M/B)

You know, I think sometimes they [accountants] kind of miss the point of some of the subheadings. (Interviewee 23 T)

Well you do need to help them [financial statements] communicate. And at the end of the day that's the fundamental purpose of financial statements, but most people are caught up in the 'we'll just do what we have to do and that's it'. They [charities] don't [pause] in the main go the extra step of going how we can make this more usable and readable for our stakeholders? (Interviewee 18 A)

This has also gained media attention, where in one television interview (Television New Zealand, 12 August 2009) the presenter said:

We also gave these accounts to ... another accountant and said look, try and make sense of it. A qualified accountant said look, it's unclear, and we can't work it out.

In response to this comment, the charity's Chair tried to avert blame away from him by putting the responsibility on to the Charities Commission

I'm not a qualified accountant and I have to agree with you [pause] I don't think accounts in New Zealand are particularly transparent. And what I want to do and what [the charity] wants to do is to try and work with other charities and with the Charities Commission to make sure that we can present these in a way that's better understood by everybody. (Television New Zealand, 12 August 2009)

This is most disappointing given that whilst GAAP has its problems, some of which were discussed in *Chapter Three* and earlier in this chapter, it is still of sufficient depth to allow a meaningful picture of the charity's financial position to emerge. The charity Chair, rather than taking responsibility for not ensuring true and fair financial statements, seeks to lay blame elsewhere. In my opinion this is a consequence of the low priority placed on financial statements. The old adage of 'why bother with the financial statements as no one looks at them' no longer holds true in New Zealand, with the publication of charities' financial statements on the Charities Register. This low priority given to financial statements is captured by the following interviewee, who sums up the situation extremely well:

Part of the problem is not so much the fact they've paid someone but the fact that they haven't paid someone and that someone is doing it [preparing charities' financial statements] largely pro bono and therefore they're taking a pro bono attitude to it. So using a different level of competence I guess - highly frustrating. But there's a problem in the [charities] sector as well in that the sector doesn't, in my view, value professional advice. (Interviewee 18 A)

Unfortunately, we don't appear to have moved far from the thirty-year old seminal work by Bird and Morgan-Jones (1981, p. 213) who wrote:

The standards of work required of a professional person are not lowered because he is doing a job for little or no fee; it would not be beneficial to anyone if they were.

Charities are complicated organisations, with difficult accounting and auditing problems which cannot be adequately dealt with by novice staff or in an odd spare hour. A practising accountant should not accept a charity audit on a non-commercial fee basis unless he is prepared to put into that audit the time and skill which its problems deserve.

This unfortunate state of affairs appears to be the case in New Zealand where numerous interviewees utilised appropriate GAAP during their paid job. However, for their low paid or even unpaid voluntary work they seemed to use no standards for auditing or accounting. What is rather ironic is that for many interviewees their 'paid' work involved hundreds or thousands of dollars but their charity work involved sums in the millions of dollars.

Whilst the sample in this thesis is small, this state of affairs cannot continue without irreparably damaging the profession of accounting. Well-meaning accountants are perpetuating this by continuing to accept unpaid or low paid work and not giving that work the quality and time expected of a qualified accountant. This continues the expectation by charities that it is possible to pay minimally for financial statements to be prepared, thus facing a rude shock when their accounts are either audited or prepared by a chartered accountant who follows appropriate standards and thus values their work accordingly. This will usually result in huge fee increases for the charity and major changes to their financial statements.

Compounding this poor level of quality in the preparation of financial statements is the low level of understandability of many working, either paid or unpaid, for charities which will next be discussed.

6.5.2 Understandability

Chapter Two identified that New Zealand operates under a system of GAAP that utilises IFRSs as the accounting basis. As highlighted in *Chapter Three section 3.1.2* one of the keys to understandability is comparability. This is achieved when ‘correct’ GAAP is used so that comparisons are then achievable between similar organisations.

The IASB considers it is essential that financial statement information be understandable by users of financial statements. However, the IASB emphasises that "*For this purpose, [the reading of financial statements] users are assumed to have a reasonable knowledge of business and economic activities*" (International Accounting Standards Board, 2005 paragraph 18, page 22). David Schmid of Price Waterhouse Coopers goes further and considers that so long as accounting standards disclose information that fairly reflects the reality of the organisation, a stakeholder can do their own sums and choose whether to support that, in this case, charity (Anonymous, 2007). This assumes that stakeholders have both an understanding of economic activities and a certain level of knowledge, which this study found was not an appropriate assumption for charities.

This low level of understanding is particularly shown by the following interviewees where charities placed reliance on auditors to tell them what to do:

Occasionally they [auditor] says things like "oh you should get an updated valuation and put it in here [the balance sheet]", but they [the auditors] haven't told me how to do it. (Interviewee 23 T)

A more common issue is [charities] with effective control over and benefit from other entities not realising that they have to consolidate and no-one has ever told them before. [This is] a hard message, especially when they are often separate legally, but caught under the accounting control definition. (Interviewee 18 Auditor)

The auditor has done it [value PPE]; I have not had any input into it. (Interviewee 21 M/T)

This study found this low level of financial literacy was acknowledged by several interviewees about themselves and the charities sector, highlighted by:

The scary part when I first came into this job [Manager of a charity] ... there is a point when you suddenly realise how much you don't know. (Interviewee 21 M/T)

The understanding of financial management in not for profits tends to be low (Interviewee 5 T/B/A)

Well what we've found is that there are two levels but it's within the organisation. So at the head office we have the accounting grunt and the understanding and therefore we do it properly at the [head office]. (Interviewee 18 A)

What was particularly concerning was that some interviewees considered they had a good understanding of the financial statements. For example, one interviewee (Interviewee 35 B/E) felt that he had a deep understanding of accounts. However, he was unable to answer some fundamental questions regarding the financial statements of the charity for which he was a Board member, whilst still maintaining that he was familiar and comfortable with the financial statements that he had approved.

A recent study in England (Connolly et al., 2009, pp. 8, 10 & 29) also found this lack of understanding from participants in their study of charities:

My view is that the users of charity accounts are the public, but they do not use them because they cannot understand them. I think that 99.9 per cent of the public cannot use these very highly sophisticated reports and accounts (Charity expert).

Financial statements were of little relevance as small funds were unlikely to understand (and therefore rely on) these documents (Preparer of financial statements).

Many charities don't understand their own accounts (Funder).

This supported Palmer and Randall (2002, p. 74) who considered that further study should be done on why charities were not complying with GAAP. One of their suppositions was that non-compliance was linked to ignorance of the requirements on the part of charities and auditors, which this study found to be correct.

Another problem my study found was a lack of interest in the financial statements, even from those preparing them, as well as charities not wanting to be bothered with the financial statements, as they see them as a distraction from the Charities' purpose.

And the governing parties don't know about it [the timing of revenue] either and normally don't want to know. (Interviewee 36 T/B/A)

I don't know what that is. The memorial fund is when somebody dies; you might make a donation to the branch in memory of someone. I would think that's what the cash fund is, but I didn't even know it was there. (Interviewee 7 T)

So, if we just have a look at your fixed assets ... Do you know how that was actually valued? (Researcher) *Before my time. (Interviewee 7 T)*

Again this supported Connolly et al's (2009, p. 10) study where some participants said:

85% of my funders give money each month but are not interested in the accounts. (Preparer 8)

Depressing to think more people read the accounts in their drafting than on publication in the final form. (Preparer 1)

What was particularly disappointing in this research was where charities took an interest and tried to understand their financial statements and had asked for help from their chartered accountant, but did not receive any. This unfortunately links with the previous section regarding a lack of professionalism by many accountants:

And they [accountants] just wouldn't help me figure out how to do this. I knew how to do the depreciation, but where I got stuck was how to record it in the first instance. (Interviewee 15 M/B)

Nobody's ever really said to us you know, the operating of this Trust is actually around restricted funds. And I'd never even thought of that, even though I knew that that was part of what we had to do as an accountable organisation. (Interviewee 16 M/T/B)

More encouraging were instances where accountants had attempted to shed light on aspects of the charities' financial statements, sometimes with success, but not always:

I would say in the last few years there has been much less jam jars which is good. It has very much been education because we've been trying to tell people that equity is one big bucket. You put it all in there [equity] if you want to tag things separately denote those by way of notes. (Interviewee 18 A)

I haven't been able to figure out a way to bridge to help them understand it; it was bad enough introducing this idea of balance sheet. All they wanted was the incoming expenditure, because they're into cash flows. (Interviewee 6 T/B/A)

Interestingly, one interviewee's response to his charity's move to full IFRS-compliance financial statements which have been deemed very complicated by many business stakeholders, was noted by:

I found it [IFRSs] slightly more complicated. We revalued all the properties. It [IFRSs] seems more realistic as your end figure sounds more realistic than

some of the other historical stuff, these properties we had for years and years and years and they have increased in value. I think the fact that you have more realistic figures far better. Although, I find it more complex to look at than the old days - I think that that might just be from habits. (Interviewee 28 M/B)

The lack of understandability within charities must be addressed to ensure charities have meaningful financial statements that can be utilised for decision making. The English Accounting Standards Board (2007a, p. 27) consider that understandability is dependent on the way in which transactions are “*characterised, aggregated and classified*” and information is shown. This supports Connolly et al.’s (2009, p. 37) view that:

Steps should be taken to improve the presentation of financial information so as to aid understandability, it is accepted that an understandability gap inevitably arises (to some degree).

This is seen in the media in New Zealand where a charity Chair on national television (Television New Zealand, 12 August 2009) stated:

We want to work with other charities [pause] and the Charities Commission to work out a way in which these figures can be better presented so that people can really understand them. I mean it is difficult to look at accounts and understand what they say. So, we want a better way of presenting that which shows all of the inputs and all of the outputs.

With the increasing accessibility of charities’ financial statements in New Zealand, charities do run the risk of casting doubt on their ability to effectively carry out their charitable mission which was highlighted by the following author in England.

Describing Sue Ryder Care’s annual report as ‘astonishing’, Mr Pitchford said: “If they struggle to produce something this straightforward, it calls into question other aspects of their operation including how diligent they are” (Womack, 2006, p. 2).

New Zealand stands on the cusp of the biggest change to financial reporting in the last twenty years (Accounting Standards Review Board, 2009; Ministry of Economic Development, 2009d). This is particularly relevant for many charities with the suggestion that medium-sized charities utilise differential public benefit entity accounting standards for their GAAP while small charities use ‘simple format reporting’ (Accounting Standards Review Board, 2009).

These standards and formats have yet to be developed. Their development will be a golden opportunity to ensure financial statements are understandable to the preparers of financial statements, who perhaps have less knowledge than a business financial statement preparer. We should learn from the experience of England and Wales where:

It was believed that those charities who cannot cope with the SORP would likely struggle even under a more simplified framework, as these would most probably be small charities with little or no in-house expertise. Without a strong

framework funders would not be able to distinguish between those charities that were doing their best to comply and those who were trying to hide something. (Connolly et al., 2009, p. 17)

It is hoped that future developments in charities' GAAP lead to financial statements that are understandable and transparent to all key stakeholders of charities rather than the opaque view that currently exists, as highlighted by the following interviewee:

The statements should be understandable but often this opportunity is not taken up... Financial reporting can hinder communication. ... Reporting should be appropriate to the audience. There is myth or mystique around the readability of information. (Interviewee 24 B/E)

Next, the last key reason for choosing particular accounting methods is addressed – the desire to appear poor.

6.5.3 Looking poor

In this study those interviewees that were aware of the matching concept tended to utilise it to 'smooth their income'. When the matching concept was explained to several interviewees they were also very keen to utilise this tool to lower their surplus where possible. This emphasis on 'looking poor' is a result of funders preferring to fund charities that 'need' the funds rather than charities that are financially sustainable. [The issue of the financial viability of charities will be further considered in *Chapter Eight*]. This attitude can be illustrated from the following interviewees who have actively lowered their assets or income so that their charity looks poorer than it actually is:

There was a balance sheet but it didn't have any fixed assets on it. Because the [charity] is worth like \$2 million. I think it was absolutely stupid. Because they think oh, people think that you know we've got lots of money. (Interviewee 3 T/A)

We got rumours that people had their eye on that money. And I don't know if you know but it's really easy to take over an incorporated society. So we moved very, very quickly to get that asset. So we said well, we don't want to attract people to our organisation because they think they're going to get a finger in dealing with this money. We put it into a trust with the same objectives as the incorporated society. (Interviewee 15 M/B)

When our bank account gets big, we move it off and then we bring it back.

(Interviewee 20 B)

So it looks like, it means I can keep control of it [Grants Held until used], I know exactly how much more money is coming up and also it looks like we're not showing a surplus because otherwise the funder looks at that and says oh, you've got too much money. I've got a separate grants spreadsheet and I know precisely what they've done. (Interviewee 23 T)

This situation is not unique to New Zealand charities but can also be seen in Australia, as the following case study (Parker, 2003, p. 368 & 369) shows.

Then for two years, Servo published audited consolidated accounts of its entire group. Subsequently, continuing director concerns about the consolidated accounts' impact on public perceptions of Servo assets and income led to Servo's annual accounts reverting to the original unconsolidated format.

The Board based its decision upon an apparent view that to safeguard Servo's income sources and financial viability, disaggregated financial statements were the preferable form of financial disclosure.

This emphasis on 'looking poor' is not a recent occurrence in charities and was initially highlighted by Bird and Morgan Jones (1981). It is disappointing that some thirty years later many of the reasons 'why' charities use particular accounting methods are based on the need to look poor. This issue is elaborated further in *Chapter Eight (section 8.3.2)* where the tension between 'look poor' to attract funding, and ensuring charities are financially viable is considered.

This section explained the key reasons why particular accounting methods were used, which is at the crux of this research, which sought to explain why charities were acting as they did. As well as 'looking poor' the other main reasons identified in this study included the lack of professional standards being maintained by accountants within the sector. When this was combined with the low level of understandability this has led to some charities' financial statements becoming quite meaningless. This situation needs to be resolved either by education or prescribing standards, both ideally supported by the Charities Commission, as further inaction is detrimental to the credibility of the charities sector as a whole.

6.6 Summary

Whilst much research has been conducted on what accounting methods various charities utilise, there has been a gap in the literature of 'why' charities utilise that particular method. This research has identified three key reasons for the choice of accounting treatments. The first relates to the lack of compliance with appropriate professional standards by accountants working in the charities sector. The second identifies the low level of financial understandability by many working or volunteering within charitable organisations. Finally, it is the aim of many charities to 'look poor' as they seek to gain more funding and this impacts the accounting method used, thereby going against the requirement for neutrality and freedom from bias when preparing financial statements.

The lack of professionalism must be addressed by accounting professional bodies to ensure the integrity of the accounting profession is maintained. The researcher has been involved with the national committee that seeks to act as a bridge between NZICA members and the charities sector by raising issues and educating both sides as appropriate. Further, education is needed, as the lack of understanding on the financial management of charities is a sector problem that must be rectified to improve the public's perception of charitable organisations.

This issue of weak financial management, in particular the drive to 'look poor', in the charities sector will again be addressed in *Chapter Eight*. Before that, the problems of complying with legislation and the issue of appropriate and sufficient monitoring will be considered next, when fiduciary accountability is examined.

CHAPTER 7: FIDUCIARY ACCOUNTABILITY

7.1 Introduction

Following on from the previous chapter considering the professional accountability aspects of financial accountability, this chapter will look at fiduciary accountability (*Figure 7-1*). While performance accountability focuses on complying with GAAP, fiduciary accountability emphasises compliance with legislation and monitoring, which are of particular relevance to this study.

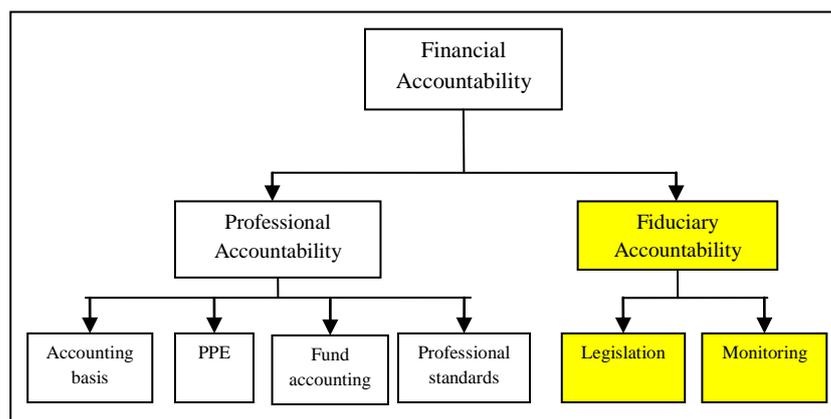


Figure 7-1 Dimensions of Fiduciary Accountability

In this chapter compliance with legislation, with an emphasis on the charitable purpose definition will be considered first. Then monitoring of charities will be analysed from different perspectives, including the role of journalists and charities' regulatory bodies.

7.2 Legislation

This study identified three compliance issues that related to compliance with legislation: charitable purpose, charities' legal structure and justification of tax foregone. These will each be examined in turn.

7.2.1 Charitable purpose definition

This study identified two issues relating to complying with the meaning of charitable purpose as shown in section 5(1) of the Charities Act 2005. The first issue relates to the narrow focus on poverty, education, religion and matters beneficial to the community, and the exclusion of purposes such as advocacy. The resulting need for monitoring to ensure the constitution of the charity is linked to its charitable purpose will be considered later in the chapter. However, the problem relating to the ease of starting charities, which has led to the Charities Commission registering two charities with similar names, will be considered in this chapter.

New Zealand's charitable purpose definition currently only has four 'heads' (*Chapter Two section 2.2*). This narrow focus limits the public's understanding of the meaning behind charitable purpose, particularly in relation to advocacy, which is explicitly excluded as a charitable purpose under section 5(3) of the Charities Act 2006:

To avoid doubt, if the purposes of a trust, society, or an institution include a non-charitable purpose (for example, advocacy) that is merely ancillary to a charitable purpose of the trust, society, or institution, the presence of that non-charitable purpose does not prevent the trustees of the trust, the society, or the institution from qualifying for registration as a charitable entity.

The New Zealand Charities Commission conducted a survey (Charities Commission, 2008e) which determined respondents' knowledge about what constituted charitable purpose. Of those surveyed 64% thought that advocacy organisations such as Greenpeace were charities and 52% considered environmental advocacy organisations were also charities. This identifies a gap in the 'charitable purpose' definition in New Zealand as any organisation that considers their prime purpose to be advocacy, i.e. the active support of their charity's mission or cause, does not meet the definition. Hence organisations such as Amnesty International (CC35331) have deemphasised the advocacy nature of the organisation. Their charity summary page on the Charities Register identifies their prime activity as undertaking research. Then follows six other activities, the last one being advocacy. Interviewees confirmed that perception with Interviewee 18 saying "*It's an interesting public argument that one because the man in the street turns to Greenpeace as a charity, people go yes, it should be.*" Also the Sensible Sentencing Trust was told that it was not beneficial to the community and that the trust's public role advocating for victims was not appropriate behaviour for a charity (Tapaleao, 2009).

Several interviewees were scathing of this exclusion with Interviewee 12 representing their feelings that advocacy lies at the heart of the meaning of charity:

Yes, well they're wrong there [advocacy not being a charitable purpose]. As long as it's not involving political, in other words supporting a particular political stance or anything else. That's what charities are for, that's why they exist. We don't just exist to get money to go spend it. You want it to actually bring about change. And you're the best ones at the coalface to know exactly what the root cause of the problems are. So of course you should go to government and say look, we know what the problems are and we suggest that maybe we look at ... If you can't do that, then what's the purpose [of charities]? (Interviewee 12 MA)

Australia has a similar problem with not including advocacy, and currently advocacy organisations there have banded together to support a charity group which was stripped of its favourable tax status because of its advocacy. This charity has won the right to

appeal against the decision to the High Court and will be supported by various advocacy organisations, including Greenpeace, Oxfam, World Wildlife Fund and World Vision, who have agreed to cover the potential legal costs of appeals to the High Court. St Vincent de Paul Society's chief John Falzon reflected their views when he said "*A vital role for charities is to advocate on behalf of marginalised and oppressed people*" (Callick, 2010, p. 1).

This issue has been resolved in England and Wales with the recent Charities Act 2006 expanding the four heads of charity to twelve specific and one general head. Two of the specific heads explicitly include advocacy organisations such as Amnesty International with section 2(2)(h) Charities Act 2006 "*the advancement of human rights ...*" and Greenpeace with section 2(2)(i) Charities Act 2006 "*the advancement of environmental protection*".

It is worth noting that the 2002 New Zealand working party (Working Party on Registration Reporting and Monitoring of Charities, 2002b, p. 12) specifically included advocacy in their proposed definition as they considered that the advancement of the natural environment and the promotion and protection of human rights "*reflects current New Zealand societal attitudes and values*". This was certainly reflected in the Charities Commission survey (Charities Commission, 2008e). It is hoped that the Charities Commission reflect on their survey's results and consider re-addressing broadening the catchment of charitable purpose along the lines of those suggested by the 2002 Working party and the England and Wales Charities Act 2006.

This potential broadening of charitable purpose is particularly important given a recent court case in New Zealand. The case was the first case questioning the Charities Commission's interpretation of charitable purpose under section 5 of the Charities Act 2005 - Travis Trust v. Charities Commission. The purpose of the Travis Trust was three-fold: (1) the provision of a prize to owners of the winning horse in the Travis Stakes; (2) support for the Cambridge Jockey Club; and (3) support for the racing industry. It was held that the Travis Trust is neither charitable nor public, and supported the Charities Commission decision to decline registration.

The potential impact of the Travis case on charitable organisations is large, as several large fund raising bodies have amended their criteria to reflect whether the organisation which is seeking funding is a registered charity. Several interviewees found this out when applying for funding, with Interviewee 16 (BTM) being told:

We have since February of last year started to process applications from organisations based on two sets of criteria, and one is that you register with the Charities Commission.

This was backed up by Interviewee 3 who was aware of an incorporated society refused funding as they were not registered with the Charities Commission, and interviewee 51 who knew of applications for funding being declined due to the charitable trusts not being registered as a charity.

New Zealand cases that related to charitable purpose before the enactment of the Charities Act 2005 include *DV Bryant Trust Board v Hamilton City Council* [1997] 3 NZLR 342 where it was determined that charitable purpose is an evolving concept, driven by changes in societal values (Tomlinson & McGlenn, 2004). It remains to be seen whether the Charities Commission will allow for this evolution in their registration of charitable organisations and broaden their interpretation of charitable purpose.

The monitoring that the Charities Commission now undertakes to determine whether the activities of charities reflects their charitable purpose will be covered later in the chapter. Before considering fiduciary issues with charitable structures, the ‘looseness’ by which the Charities Commission is registering charities with similar names is identified.

To register a company the first thing you have to do is register the proposed name of the company to ensure that no one is using the name, and this is explicitly shown in the New Zealand Companies Office first instruction regarding how to incorporate the company (Companies Office, 2010). The Charities Commission does not appear to be following this practice as, on doing some research on a charity whose Treasurer was going to be interviewed for this study, the researcher found two charities with the same name apart from the addition of the word ‘Maori’, a fact the Treasurer and the charity were unaware of:

No, [pause] we’re this one. I didn’t even know about this one. Oh, we better be careful because this [the charity with the same name], is a Maori trust. Oh goodness, have they been going since 1972 and we pinched their name? That’s really bad. Oh, [pause] because we use their name as a short form of our name. I better check up on that because if we’re using a name that’s already being used by a Maori group, then it’s not very good. (Interviewee 23 T)

The registering of charities with similar names or causes is seen when doing a search of the New Zealand Charities Register on the word ‘cancer’, which produced 63 results. The many names for the one cause can lead to confusion. The Charities Commission

needs to ensure that charities are not registered with similar names, to limit confusion between similar sounding charities. This may not be easily achieved as the Charities Commission's focus when registering charity is on whether the proposed charity meets their charitable purpose, rather than whether there are already charities that have similar names. The issue of the profusion of charities with similar causes will be addressed in *Chapter Eight (section 8.4.5)*.

The narrow focus of New Zealand's definition of charitable purpose needs to be reconsidered, particularly the explicit exclusion of 'advocacy'. Some interviewees have argued that advocacy is an essential part of charity's role in society. This has been acknowledged in England and Wales by the inclusion in their Charities Act 2006 definition of charitable purpose, of advocacy, in section 2(h) "*The advancement of human rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity.*" Trevor Garrett, the Chief Executive Office of the Charities Commission, has advised charities to consider splitting their organisations into two and putting the 'non-charitable' advocacy work into a separate unregistered organisation (Collins, 2010a). This does not address the crux of the problem, i.e. that advocacy should be part of the charitable purpose, not excluded.

Another issue identified in this research was the registering of charities with very similar names. This issue needs to be considered by the New Zealand Charities Commission when they next review the registration of charities. Another aspect of charities registration, that of too many charities for the same causes, will be addressed later in *Chapter Eight (section 8.4.5)*. Another legal aspect of charities is its legal structure, which will be examined next.

7.2.2 Legal structure

As detailed in *Chapter Two*, New Zealand has no prescribed legal structure for charities. Thus a variety of structures is seen. As shown in *Chapter Two* charitable trusts constitute 45% of registered charities as at February 2010 compared with limited liability companies (30%) and incorporated societies (25%). The reason behind choosing a particular legal structure is not always understood, especially with regards to a limited liability company, as can be seen by the following case.

On the face of it a company with shareholders, rather than beneficiaries, does not appear to be an appropriate vehicle for a charity. To determine who shareholders are an

analysis was done of the first company listed after the search ‘limited’ which was ‘139 On Union Limited’. As can be seen from *Figure 7-2* the ultimate ownership was by two registered charities 43% by Baptist Action (CC25757), a charitable trust, and 57% by Baptist Union (CC22731), which was missing the details needed to determine their legal structure.

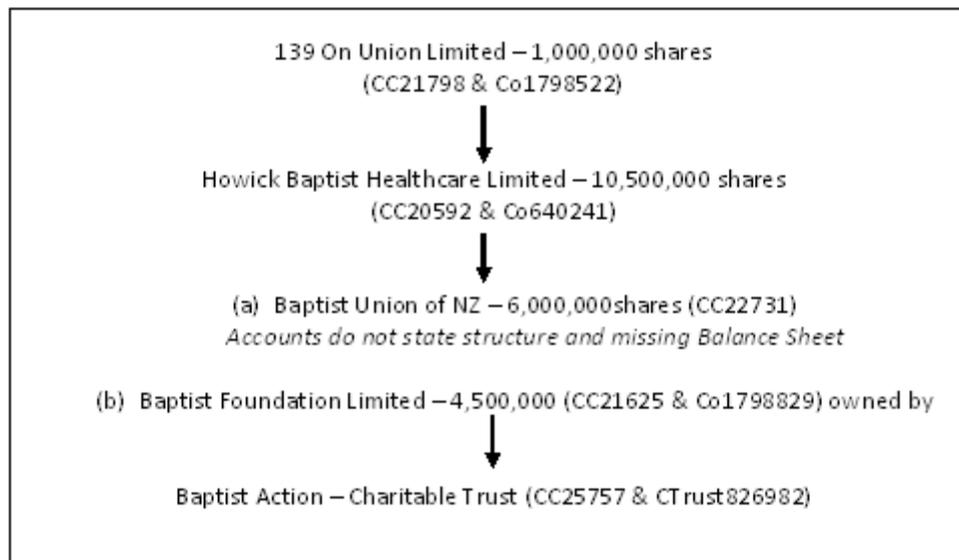


Figure 7-2 Ownership structure of 139 On Union Limited

Given the ultimate owners were both Baptist run organisations it is hard to determine why the Baptists chose to incorporate as a company with a name, i.e. 139 On Union Limited, that does not explicitly link to the Baptist religion. Also a company structure seems to fit more in a ‘for-profit’ role than a charitable role and thus is not necessarily as transparent as a charitable trust, as it does not focus on the pursuit of a ‘public benefit’. The structure of 139 On Union Limited also highlights the problem of consolidation, previously discussed in *Chapter Six*, as it appears that neither of the owners include 139’s results in their financial statements.

Incorporated societies are another legal structure that includes the notion of ‘owners’ although instead of shareholders, societies have members. The idea of members again does not appear to link with the notion of a charitable purpose. Particularly fraught is the ease with which incorporated societies can be ‘taken over’, as seen by the following interview:

And I don’t know if you know but it’s really easy to take over an incorporated society. Yes, and all you have to do is have some people sign up as members during the year, show up at the AGM, vote their people into the thing, and it has happened. (Interviewee 15 BM)

Actively moving assets into another organisation, such as a charitable trust, previously 'hid' them from public eye. However, with the advent of the Charities Register it is now more transparent, if charities keep similar names, whether charities have both incorporated societies and charitable trusts. It will be interesting to see whether the common practice of separating the money into a trust become less utilised.

The question remains as to whether New Zealand needs to follow Australia's route in prescribing a specialist legal structure for all NFPs, including charities (Productivity Commission, 2009). Yes, there may be more transparency than that afforded by a company and incorporated society, assuming the new legal form did not allow distribution of assets or profits to individuals. However, unlike Australia with its inconsistencies of legal structures across its many jurisdictions, New Zealand is, fortunate, to have only one jurisdiction. The Charities Commission is trying to resolve the weaknesses in company and incorporated societies' structures by ensuring that all organisations applying for registration as a charity have three clauses in their constitution, concerning: (1) that the organisation's purpose is charitable; (2) that all monies must be used to advance its charitable purpose rather than receive private profit for their shareholders or members; and (3) that a winding-up clause ensures any assets the organisation has will be directed towards organisations with similar charitable purposes (Charities Commission, 2006e).

So whilst the Charities Commission may be strengthening the legal structure of companies and incorporated societies to make them more appropriate for a charitable vehicle, this does not resolve the public perception that shareholders and members are not appropriate for a charitable organisation. This was highlighted by Cullen et al. (2001, p. 34) who considered that in relation to companies:

It is not always clear whether profits of commercial operations carried on by, or owned by charities are distributed to the charitable purpose for which the entity was established.

One interviewee compared the three very succinctly:

Your options for organisational structure were a limited liability company, incorporated society, Charitable Trust or individual. Now, with the purpose of trying to obtain public support for a cultural endeavour, a limited liability company is a profit making company you know, benefiting the directors, so that wouldn't work. Incorporated society is completely top heavy, needs too many members and a complete pain in the arse. So a Charitable Trust is what we opted for. (Interviewee 16 BTM)

Also the idea of members ‘taking over’ a charity for their own purposes is still a risk for incorporated societies. However, the concern is that the transition cost of moving all registered charities to a single legal entity, as recommended in Australia, would be significant and thus the costs would outweigh the benefit (Productivity Commission, 2009). This is particularly so, if the general public trusts the Charities Commission to ‘tighten up’ the rules of companies and incorporated societies to ensure charitable intent and no personal gain. Next, the issue of the need to be accountable for tax forgone is examined.

7.2.3 Accountability for tax forgone

Governments forgo taxation revenues by granting charities donee status where donors can claim a rebate (Inland Revenue Department, 2009) and income tax exemption (Inland Revenue Department, 2005). However, Cullen, Swain and Wright (2001, p. 34) point out that these subsidies are not subject to the direct control of government and “*No such accountability is required for the charitable tax exemption to be accessed*”. This view was supported by a 2002 Working Party, which commented that successive governments have “*expressed concern about the degree to which [the] tax exemption for charities can be used for tax avoidance*” (Working Party on Registration Reporting and Monitoring of Charities, 2002a, p. 3).

The need for justifying taxation forgone has been highlighted in Australia where the Senate Standing Committee on Economics (2008, p. 130) said:

Accountability is an important operational issue for all ... [we] are entitled to, information about the finances and operations of [charities] in return for their donations, voluntary activities and taxation exemptions and concessions. It is argued that it is in the public interest for [charitable] organisations to be more transparent and accountable, as they attract significant public funds through tax concessions.

Eisenberg (2005, p. 171) also considered that there was an obligation on people establishing charities, especially private philanthropic trusts, to justify the tax forgone, as noted by the following American example:

Harry Weinberg could have kept or given away his money without creating a foundation, in which case he would have had to pay taxes to the federal government. But he chose not to, preferring to create a foundation, thereby avoiding substantial tax payments. In exchange for those tax benefits, he made a compact with the American people to meet urgent public needs in a publicly accountable way.

The cry for accountability for tax foregone has been seen in New Zealand where Gousmett (2010, p. 6) writing in a recent publication of the New Zealand Federation of Voluntary Welfare Organisations said:

Why should charities be held accountable? Fiscal privileges – Charitable trusts that have registered with the Charities Commission, then gain status as tax charities. As well as being exempt from income tax, gifts and bequests are exempt from gift duty and donations qualify for tax credits.

To a certain extent this issue has been resolved by the Charities Commission monitoring registered charities. However, there are issues with their monitoring which will be discussed later in this chapter.

Most charities do not consider there is any need to justify tax forgone. They consider that the income taxation exemption over donations and interest is a right with no resulting need to justify that right. This was highlighted by Interviewee 12 who comments:

When you next talk to a charity manager, ask him “Do you consider that you are subsidised by the Government from two perspectives – firstly, the exemption from income tax and secondly through the donation and rebate subsidy, the tax credit”. And they will say no, of course we’re not. But they should be required to file a tax return with the Inland Revenue Department justifying your activity.
(Interviewee 12 MA)

This view was shown by one interviewee who discounted the exemption over donations with:

Yes, the income tax exemption is not such a big drama, because if all your income is donations anyway so what? (Interviewee 14 MA)

This feeling of justified taxation benefit is particularly seen in religious organisations that were reluctant to provide information about their activities, as seen from Interviewee 4 (BA), who was reluctant for their information to be on the register “*Because it’s very sensitive information*”. The interviewee did not consider that their religious organisation was accountable to the Government “*because a group of churches are accountable to a higher level [God]*”. Also the interviewer was unable to obtain or even sight the financial statements of most of the religious organisations she interviewed and none had yet to file an Annual Return.

Blundell (2008, p. 3) muses as to why non-believers should pay more tax to help fund the often secretive ‘charitable’ work of religious organisations. She considers that “*If you’re not paying tax that’s a privilege and everyone should have transparent and audited accounts.*”

The transparency of their organisation acted as a deterrent for one religious organisation that was constituted as a charitable trust but had chosen not to register:

It [registering as a charity] wouldn't provide any more advantages to the Trust ... but would place a disproportionate amount of compliance in terms of disclosures and filing and so on, which we're not that geared up to do. (Interviewee 6 BT)

In England, Morgan (Morgan, 2009a, 2009b) has been rather loud in his denouncement of these religious organisations saying that:

It would be absurd if churches are to be allowed indefinitely to claim the tax benefits and reputational benefits of charitable status without meeting the same standards of accountability as other charities (Morgan, 2009b, p. 346).

It would be anachronistic for Christian churches to continue to receive the benefits of charitable status without the normal standards of accountability (Morgan, 2009a, p. 361).

The situation in New Zealand has changed with several religious organisations choosing to register as charities perhaps without fully understanding the impact transparency would have. This was particularly seen in the case of two religious organisations that last year declined to make their financial statements available:

Mortlock declined to release a copy of City Impact's financial statements for this story, claiming churches have a right to privacy. Destiny Church was also asked to release its financial statements for this story but refused, saying it has no obligation to make its figures public (Casinader, 2009, p. 56).

In the case of Destiny Church, one year later, thanks to the Charities Register, their financial statements were submitted under eighteen separate regions, which showed donations of nearly NZD6 million (McCracken, 2010). Interestingly, to obtain this figure the reporter would have had to go through each of the eighteen separate regions financial statements as no consolidation of Destiny Church took place, a common problem amongst charities which was highlighted in *Chapter Six*. If Destiny Church's donors applied for the donations rebate this would mean that the Government would potentially have to pay Destiny Church's donors up to NZD2 million - a not insignificant number.

This need for secrecy is not held by all religious organisations as can be shown by:

Steve Farrelly, of the Christian-based Life Impact Trust, says churches should be more transparent about their funds. If you're an urban church with 5000 people who tithe 10 per cent, you're bringing in several million a year. How much of that reaches the community? In some cases, churches just keep buying assets. Yes, they can bring in large amounts of revenue, but it should be redirected to those who need the help (Casinader, 2009, p. 57).

With regards to justifying taxation forgone there currently is a regulatory gap between registered charities that are exception monitored, to ensure compliance with their charitable purpose, and other charitable organisations, where no monitoring exists apart from those detailed in *Chapter Two (Section 2.6.2 Taxation Agencies)*, which are currently not being utilised. For example, only approximately 10,000 charitable trusts registered out of a total 15,000 charitable trusts on the register meaning that 5,000 charitable trusts currently do not have to justify the activities of their charitable organisation or even justify their financial spending. A media report fifteen years ago highlighted the problem of lack of monitoring and this is still a potential problem:

A 42% leap in charitable trusts in five years, and the lack of official vetting of their accounts, has charities worried that trusts are being used as vehicles for tax dodges.

There is no hard evidence that this is the case. But neither the Inland Revenue Department, nor the Justice Department administering these Charitable Trusts Act, can be sure there is no widespread abuse of the tax-free status that comes with registration as a charitable trust.

Charitable trusts appear to have escaped the close scrutiny that accompanies company accounts because government officials have faith in their charitable purpose. (Booker, 1995, p. 3)

To take the lack of active monitoring wider, whilst the Charities Register contains 24,319 charities (Charities Commission, 2009d) Statistics New Zealand estimates that there are approximately 97,000 NFPs (Statistics New Zealand, 2007) most of whom would have either been granted donee status or given income taxation exemption.

So why is it important for there to be a culture in New Zealand of justifying taxation forgone? Statistics New Zealand considers that NFPs contribute 4.9% of New Zealand's gross domestic product (GDP) and that NZD1.9 billion of NFP's income relates to donations which constitutes a potential taxation liability of 33% of the total (Statistics New Zealand, 2007). Currently, there is limited accountability on whether these organisations are utilising funds to their NFP or charitable purposes and consequently are deserving of the taxation benefits. There is a need for the public to feel confident that money that could otherwise be spent on the 'public purse', for example health and education, is being utilised for charitable purposes.

This chapter has highlighted the need for legislation to be backed up by appropriate monitoring of charitable organisations, which will be discussed next.

7.3 Monitoring

As discussed in *Chapter Two* there is an assumption that the people involved in charities are trustworthy and hence charities are free from traditional oversight, as the commitment of their shareholders were thought sufficient to produce positive results (Mueller et al., 2005).

A survey commissioned by the England and Wales Charity Commission found that a large part (88%) of trust in charities is based on an ‘inherent belief’ in charities being altruistic and thus trustworthy in nature, rather than any rational knowledge on how they operate (Opinion Leader Research, 2005). Opinion Leader Research (2005) identified that there was a lack of oversight and limited knowledge over how charities are managed. They considered that this “*suggests that trust in charities could be based on shaky foundations and that it is potentially vulnerable to the same kind of decline seen in trust in the public and private sectors*” (Opinion Leader Research, 2005, p. 23) .

To have support in case the inherent belief in trustworthiness is unfounded, there is a need for both external and internal monitoring of charities. Externally, the most common form of monitoring is conducted by the Charities Regulatory Body, in New Zealand’s case the Charities Commission. Internally, the Charity’s Board can pay a part in oversight either personally or by ensuring assurance is performed on the charity’s financial statements. Finally, the charity themselves may choose to implement some internal controls to ensure operational activities are strengthened.

Before going further, an explanation is needed of the monitoring bodies identified in *Chapter Two* and where, if at all, these will be analysed. Rather than focusing solely on the monitoring aspects of charities’ funding bodies and rating agencies these will be considered in *Chapter Eight* in relation to the wider view of reporting to stakeholders and how this can be transparent and understandable for all stakeholders. Monitoring by taxation agencies is covered in this chapter in relation to justification of taxation forgone. Next, monitoring that takes place by the Charities Commission is investigated.

7.3.1 Charities regulatory bodies

Cullen et al. (2001, p. 33) in their report entitled ‘Tax and charities: A government discussion document on taxation issues relating to charities and non-profit bodies’ bemoaned the lack of monitoring in the charities sector:

Apart from random Inland Revenue audits and the provisions of the Charitable Trusts Act, there is no process for monitoring whether [charitable] entities are pursuing the charitable purposes for which they were set up.

This lack of monitoring is no longer the case for registered charities with the establishment of the New Zealand Charities Commission which, under section 50 of the Charities Act 2005 has the right to make inquiries into charitable entities and related people. As identified in *Chapter Two* the New Zealand Charities Commission's monitoring is exception driven rather than, at this stage, going through individual charities for which no complaints have been received. On March 2010 the Charities Commission released an information sheet regarding their decision to publish their declined applications for registration and the decisions to remove any organisation from the Charities Register (Charities Commission, 2010b). These decisions can be viewed at http://www.charities.govt.nz/guidance/dereg_list.html. Some of the deregistrations have enraged the organisations concerned and the Charities Commission will have to defend their decision through several upcoming court cases including that of Greenpeace (Collins, 2010b; Rudman, 2010).

Trevor Garrett, the Chief Executive Officer of the Charities Commission (Garrett, 2010), in their recent 'Update Newsletter' indicated a broadening of the monitoring function:

The Commission hopes to contribute to a 'virtuous cycle' that will sustain the public's trust and confidence in charities, and in turn, give them the assurance they need, so they continue to donate. By ensuring that the public is well informed about your charity in particular, and the charitable sector in general, we can all help to build trust and confidence, and assure the public that their donation truly is making a difference (Garrett, 2010, p. 2).

This was supported in June 2010 with the publication of the information sheet 'Understanding Charities Commission Compliance Actions' which includes the use of a Charity's Annual Return to investigate the activities of the charity (Charities Commission, 2010d). This supports Trevor Garrett's opinion that the Annual Return is the key to a charity's action, as seen by his comment on Television's Close-up programme:

Well, what we suggest they do Mark is go to our register. Ah, that gives all of the information that you really want to know about the organisation, who's involved with running it, what the rules of the organisation are, and what the finances are (Television New Zealand, 27 July 2009).

This is contrary to several knowledgeable interviewees who stated that the Annual Return details are what are required by the Statistics Department and the Department of Internal Affairs, as the following interviewee highlights:

It's [Charities Commission Annual Return] not being done from the point of view of what are we trying to show to stakeholders. This is coming from a [New

Zealand] *Statistics Department point of view. And that comes from the Charities Act 2005 which one of the ten or eleven things that they actually have to do is to gather information about the population of charities in New Zealand.* (Interviewee 18 A)

Also, Annual Returns do not tell the full story about the charity, as shown in the following quote:

Annual return forms for registered charities requires much financial information, but little about whether the charity is achieving its mission - outcomes. (Interviewee 25 M)

Further analysis of the Annual Return shows some serious weaknesses including the absence of any reporting on the outcomes of the charities' activities (further investigated in *Chapter Eight*). One has to question how the Charities Commission can use the Annual Return to see if a charity's spending on activities is related to its charitable purpose, given the limited transparency and understandability that this research has identified in *Chapter Six*. Also, the Income Statement usually gives no indication of what actual activities might have taken place, as expenses are reported alphabetically by category, e.g. telephone, rent, etc rather than by activity.

Compounding this issue is the lack of quality in the actual completion of the Annual Return by charities which was highlighted by numerous interviewees, but rather eloquently by the following two interviewees:

The groups I work with, what they'll do is just give the whole form [Annual Return] to someone they trust to fill it all in. And then they'll wave it in front of the nose of the Chair of the Board and say "So and so says this is OK", and they'll scribble anything on it. (Interviewee 15 BM)

What will happen is ... you kind of get to the stage where your job gets too hard. You guess - that looks about right there, does it all add up? It looks good, yes. Who's going to check it? The thing is, unless you can make something simple and easy, you really are wasting your time because it's not the business of charities to do all this stuff [filling in Annual Returns]. The business is out there [Gestures to the outside world]. (Interviewee 28 MB)

This lack of care was seen by the researcher when reviewing the Annual Returns of charities, to find that the accounting equation did not always hold true, i.e. assets did not equal liabilities plus equity. This was compounded by the fact that the Charities Commission has not yet incorporated any checks to highlight input errors.

Of particular concern is the large number of charitable organisations who have chosen not to register and hence are not 'caught up' in the Charities Commission's monitoring 'net'. Nearly 33% of charitable trusts have chosen not to register, whether for a lack of interest (as the next interviewee alludes to), or deliberately not registering due to the

level of transparency required (as the second quotation suggests):

There's been no discussion around becoming a charity I guess. What are the merits? No one is there to advise us. (Interviewee 21 MT)

The real motivation for registering with the Charities Commission was the donee status. Now that the donee status is still with the Inland Revenue Department, and we still qualify for that, then the drive to register the [charity] with the Commission had gone away. Now, the only thing that we compromise is the exempt status. But because of the income that is taxable [some interest], it's not worth it. (Interviewee 6 BT)

As stakeholders become used to having financial information for charitable organisations, there will potentially be a resulting demand for these charitable trusts to supply information. Where those charitable organisations do provide financial statements and other information, such as registered Charities' Annual Return, other monitoring will be needed, such as the monitoring of charities by their Boards, which will be examined next.

7.3.2 Charity Boards

Charities' Boards are charged with the governance of their charity and an effective board monitors the strategic direction of their charities, ensuring that sufficient controls are in place to monitor performance within the charity.

This research uncovered several weaknesses in relation to Charities' Boards including a lack of understanding of what their purpose was, i.e. a lack of understanding of the duty of governance. There were also several instances where the person placed in charge of the operations of charities, such as a Chief Executive, wielded too much power with resulting limited controls between the Board and the Chief Executive. The worst cases were charities with a vast division between the Board and the Charity limiting the inability of the charity to achieve success in its mission. However, before discussing these matters issues relating to the composition of the Board needs to be considered for, as with a well-run car, there is a need for all its 'parts' to be operating effectively, which in the case of charities' Boards are their Board members.

It was heartening to see many truly altruistic people who were battling to ensure the success of their particular cause. A big barrier that many interviewees perceived to exist was incompetent Board members. Some of the poor decisions made in appointing these people to the Board were related to the charity's rules, or lack of them, on how Board members were appointed resulting in the situations seen by the following interviewees:

There was a sub-committee running [the charity] with a person who had been doing it for 20 years. And she always asked for volunteers, and basically she had a committee of 4 or 5, one person had Alzheimer's, [pause] one person was severely ill and in hospital more than not, but they wouldn't get rid of her because her father set it up. This was a woman who really saw her role as driving the Alzheimer's person and the other sick person back and forth to meetings. And since she had to wait for them, she might as well be on the committee. (Interviewee 20 B)

The members that are currently on the Board there, if you looked them up at the moment, [pause] um [pause], what's a nice way of putting it? Well the way you get off the Board and the Trust is you pass away. And it's got to that point where they have only been meeting about once a year, and they're not passionately interested in [the charity] but they're [pause] - I think all but one of them is - on the other side of 80+. (Interviewee 29 MB)

It appears from these quotations that well-meaning people, who consider they are doing the charity a good service, may be hindering the chances of the charity succeeding in its role. Unfortunately, a lot of the examples related to the age of the Board members, but this was by no means universal and people in their 30s were sometimes perceived as equally problematic as people in their 80s. There was reluctance by many Board members to change the 'status quo' even though it was not working, as the following interviewee highlights:

I had to wait for the old regime to move on for me to, you know, to start new things. Except that people are comfortable with the past, although they know that it's not right, and change is hard. (Interviewee 4 BA)

Those well-meaning Board members who considered they were doing 'their bit' for society in many cases were perceived to have an appalling lack of understanding of the governance required of their Board and their particular role in governance:

Not many Board members in my experience actually realise the duty that they have. They don't understand how they should operate. Very few of them self assess or assess as a group. So they don't follow good boundaries. In a lot of cases, they don't follow good structure; in fact they don't follow much protocol at all. Many of them have never seen a director's handbook of policy, or policy direction. (Interviewee 29 MB)

This interviewee further highlighted the self-interest that many Board appointees had:

So they often come in with their own agenda. They don't take their hat off at the door. They forget that they've got a certain fiduciary care in terms of how they operate as a Board member. And they come in with their own personal agenda or their own view of what they're there to do. For example, I'm here to clean things up or I'm here to do whatever they want to do. And they actually don't step back and think about what their role as a Board member is to do the best for that organisation and follow the values and the vision of that organisation. And if they don't like the values and the vision of that organisation then fix the constitution. (Interviewee 29 MB)

This focus on the constitution was also highlighted by the following quotation:

I tried to narrow down what the problems were and one of the major problems was no one had governance responsibility. One issue was that they had no quality assurance system, which normally wouldn't matter, but that was a condition of our funding. We had signed off that it was there when it wasn't. Another issue was that there was no strategic plan, direction, consultation, or anything. In fact, the people that ran the committee didn't even know what the constitution of the [the charity] said. Most people couldn't tell you what the constitutional purpose is. They think the constitutional thing is something you file, it becomes historical and it's got nothing to do with the charity's activities. But if you say you're doing this, you've got to be doing this. (Interviewee 20 B)

With this lack of ability came a willingness to allow the Chief Executive to 'take over' many of the Boards' duties, as was noted by several interviewees. Sometimes it wasn't the Chief Executive that had too much power but a division within the Board, as shown in the following situation:

The executive made decisions that the rest of the [Board] didn't know about, as they hadn't communicated with the [Board]. If you don't communicate, you end up with a little clique knowing what's going on and you end up with misinformation and speculation and people thinking they know the answer, when actually they haven't got the right answer at all. (Interviewee 14 MA)

In several situations the misinformation caused a breakdown between the charity and its volunteers and paid employees on one side and the charity's Board on the other side. This limited the charity's ability to effectively carry out the charity's mission:

They [branches] didn't trust the national office and were convinced that their money would not get spent on [them]. The biggest problem within this association was the lack of communication. (Interviewee 14 MA – emphasis added)

The staff decided they couldn't work with the committee, and the committee decided they couldn't work with the staff. (Interviewee 20 B)

One duty of charities' Boards is to ensure the financial statements of the charity reasonably reflect the activities of the charity. In many cases Boards relied on the ability of external assurance to provide them with confidence over the financial information. This provision of assurance services will be examined next.

7.3.3 Assurance

The provision of assurance services to charities is in many cases imposed upon charities not by their boards but by their funding bodies. There are two main types of assurance used in the charities sector, the most popular being an audit, and gaining in popularity is the review, which the following interviewee supports:

Reviews are more manageable than audits for many organisations – especially

useful for smaller organisation and for smaller grants (Interviewee 24 B).

Unfortunately, limiting the success of reviews is the confusion of reviews with the term audit, as this interviewee found:

Oh, no, no, well we always use the term audit, but we mean review. And I said well, you know, that's really dangerous. (Interviewee 3 AT)

This study revealed many examples of inadequate professional standards shown by accountants acting in the role of auditor. Issues included: a lack of independence from auditors; problems with financial statements not being picked up by auditors either previous or current; and a lack of understanding of the charity by the auditor. Of particular concern were auditors who were producing poor quality audits leading to a lack of value seen by charities in having an audit, apart from the fact one was needed for funding purposes.

The foundation of auditing is a requirement to be independent. Without independence, the purpose of the auditor performing an external verification on the financial statements is not achieved (New Zealand Institute of Chartered Accountants, 2003a). One tenet to maintaining independence is that auditors must not prepare the financial statements, which is contrary to the experiences of some charities:

That [balance sheet] was created by [the auditor] because I couldn't, I didn't even know where to start to create a balance sheet, so the auditor actually did it for me. (Interviewee 7 T)

The auditor has done it [value land and buildings], I have not had any input into it ... but these figures that he's just churned out. I would expect an auditor to highlight that sort of thing to me. I wouldn't expect to be able to gain that for myself. For me, I'm thinking that seems strange but again, one would have to trust in the value of the profession, and his professional standards that this is acceptable practice. (Interviewee 21 MT)

In many small charities the auditor may be the only person capable of preparing the financial statements, so as one interviewee put it this leads to “*Auditors telling charities how to do their accounts*” (Interviewee 1 A). Hence their role becomes an accounting role rather than an audit role and no independent, external verification is achieved.

Palmer, Isaacs and D'Silva's (2001) United Kingdom study found problems with the calibre of auditors. They found that over a third of their sample had non-compliant accounts, which were signed off by auditors who claimed to have expertise in charity auditing. An earlier study found similar results in New Zealand where 76% of charity auditors did not identify audit failures (Newberry, 1992).

It is disappointing that the situation does not appear to have improved since Newberry did her study nearly twenty years ago. This was particularly shown in one charity that received a clean audit report, even though their charity's financial statements did not balance (Interviewee 46 AMB).

This lack of quality raised the ire of one interviewee who questioned NZICA's role in monitoring this:

Some of the audits I've seen from the big four are clearly material on the issues [that were identified during the audit]. And they still have given clean opinions. A couple of the local firms here I've pulled accounts. At one stage I threatened the Institute [NZICA] that I was going to burst out with an audit conducted by each major and second tier firms which was an example of them not complying [with auditing standards]. (Interviewee 11 BTA)

As well as giving incorrect opinions auditors lack of understanding in the charity was at times embarrassing to see, as a fellow member of NZICA, an ex-auditor and an auditing lecturer:

The auditors were useless, I thought they might be able to help me. They were hopeless. They shrugged their shoulders and walked away. (Interviewee 13 BA)

Like he's put it [the charitable trust] as a company not a Trust and those things are...they're errors. And they're clearly mistakes. (Interviewee 16 BTM)

That's [referring to financial statements] set out the way the auditor sets them out, and audits them. These are grants, the auditors called them donations. (Interviewee 23 T)

Another auditor threatened to give an unclear audit opinion unless the expenses were 'properly shown'. In his view this meant expenses in alphabetical order rather than by charitable activity, which would have made the accounts more meaningful to the users including the Charity's Board:

I don't like this straight line stuff [putting expenses in alphabetical order in a straight line with no sub-headings]. I think sometimes they [the auditor] kind of miss the point of some of the subheadings. (Interviewee 23 T)

There were many examples of older, and in many cases, retired members of NZICA who considered they were doing their civic duty in conducting audits. Unfortunately, these audits were at times nothing more than an analysis and interpretation of the financial statements. This situation leads the charities sector into assuming that it is possible to get an auditor for a minimal payment or even on an honorary basis. Thus, when a charity moves to a professional auditor who follows all the appropriate auditing standards, the charity's audit fee increases dramatically as in the following cases:

Unfortunately a lot of the time it's older members - very well meaning people. But you know, they last studied in 1950 and they don't see why they need to

change and they're doing a good job donating most of their time to the local parish or whatever. (Interviewee 18 A)

The audit cost ten times what it cost the last time and [the Board] gritted its' teeth. I told them they could consider themselves thankful and fortunate that for the last 10 years they've had an audit done, and that nothing's gone wrong in those 10 years, because in fact we had an auditor who had the nose and knew the things that really mattered. Practice Review [NZICA's monitoring committee] started to hound him and he eventually just chucked it in, he said it's not worth it. (Interviewee 11 BTA)

Not using auditing standards led to audits where the auditor had qualified the audit report because they could not sight every single asset rather than just sighting the material ones. No questions were asked as to whether there were any controls over these assets, which should have been the focus of auditing PPE:

Now I personally don't think that an auditor has to go and sight every jolly fixed asset. I never did. That's just crap. So that's what the previous one did. And I mean, frankly if she wants to put that qualification [on the audit report] I frankly couldn't care less. (Interviewee 14 MA)

The other extreme was where auditors never visited the charity, as seen in the following:

No, well I think my inclination was to go and actually have a meet with this guy [the Auditor] anyway and talk, rather than just fill out forms and never actually meet the guy. (Interviewee 21 MT)

Several interviewees were very grateful that someone was auditing their accounts, seeing an audit just as a funders' requirement rather than appreciating the benefits of a 'properly conducted' risk-based audit which identifies risks that the charity needs to mitigate:

A well meaning chap [the auditor], who was very slow and there was lots of typos from the firm that was doing the writing up. And now, he's very sick, and basically retired. Now I've gone to another one and he's very slow. I sent the first lot [audited financial statements] back with all the typos and the fact that they left a column out (Interviewee 23 T).

This interviewee wanted an audit report as it was a requirement of her Board and funders. The auditor restated her figures into a different format that interviewee 23 did not understand so she provided her Board with her original (unchanged) financial statements not the audited financial statements.

This lack of understanding was identified by Fisher (2007a, p. 23)

In my experience, many within the not-for-profit sector do not truly understand what an audit or a set of generally accepted accounting practice compliant financial statements are.

The following quotation illustrates this problem in relation to a charity which had assets of NZD600,000 and income of NZD650,000. The charity went from an audit fee of NZD4,000, a fee actually on the low side, to an audit fee of NZD750. It should also be noted that the charity's new auditor and the charity are at opposite ends of the country and the interviewee advised that she had not met the auditor personally:

They've [the previous auditors] got very fancy letterhead and they seem to be something ... And we were paying them a fortune [NZD4,000]. And a guy, one of our Board members, said oh, this is a ridiculous amount to be paying to the auditors, would you like to use our auditor? So, oh yes, that's a great idea. (Interviewee 20 B)

With all the bad examples it was heartening to find examples of competent auditors who were excellent examples the auditing profession should emulate:

They [current auditors] know what to look for, so they come in and ask the right questions and they're actually looking in the right places for the things that you know that they should be looking for. (Interviewee 29 MB)

And most of these audits that you get asked to do, have significant problems because they do not comply with all sorts of issues and are you going to insist on full compliance with all these requirements, or am I going to insist on some minimum level of requirements that I'm comfortable with. You just get into difficult, ethical situations which probably you're better off if you don't even know about them. But if you do know, you can't ignore them. And the audit reports don't comply with the auditing standards either. (Interviewee 11 BTA)

Every time I hear from a client "Oh, we're a very simple and straightforward organisation" and you're asked to quote on it, why is it so much? It's because I've been burnt so many times before. And I'm a lot harder now about that. I'm not anywhere near as apologetic as I used to be about what we charge because I am so used to being burnt, it's 99% of the time. (Interviewee 18 A)

As Fisher (2007a, p. 23) highlights:

In the past many [charities] have relied on finding a friendly chartered accountant who is willing to perform an audit on an honorary or semi-honorary basis. Potential auditors are also deterred by an increase in professional liability and risk; that concern applies equally to non-paid engagements.

Some Auckland auditors have identified the need for training and have set up the Auckland NZICA Audit Special Interest Group which have speakers come in and explain various matters of importance. At one meeting that the researcher attended, the presenter asked who had read a particular audit standard. This audit standard was the key standard for audit planning, which the presenter considered should take at least one-third of audit time. Out of seventy people, three, including the presenter and the researcher, had read the standard. Compounding this is the fact that many auditors do not see the necessity of up-skilling, which was remarked upon by one interviewee: "The

problem that you've [pause] we've probably got is that the ones that need to won't go to the [Audit SIG]" (Interviewee 36 TAB).

As revealed in *Chapter Six*, this lack of quality in professional standards is an issue that must be addressed by the profession. The Government has acknowledged this problem with auditors and is currently drafting up legislation that will require registration for auditors (Power, 2009). However, at this stage, the requirement is only for audits of issuers. This potentially introduces a two-tier audit level and implicitly supports the lack of quality shown by charities' auditors. When the researcher asked people within the Government the reason behind this narrowing of scope, the unanimous feeling was that they didn't want to make it too hard for charities and others within the NFP sector to find an auditor. Thus implicitly supporting the low level of quality audits that are currently being undertaken in the charities sector, and this is a situation that cannot be allowed to continue.

The solution is two-fold. First, it is necessary to address the reason for needing an audit, i.e. funding requirements, and identify whether it is an audit these funders require or just an agreed-upon procedure that ensures the funds they provided have been appropriately spent. Second, there is a need to educate the charities sector and their auditors on risk-based auditing and the benefits of doing this for a charity. Thus whilst a charity's funder may not need an audit the charity's Board could consider that having an audit enhanced their accountability to all their stakeholders, and be prepared to pay for a quality audit.

The need for some external assurance of charities' financial statements becomes more important, as many charities have limited, if any, internal controls that would mitigate some of their risks. This is discussed next.

7.3.4 Internal controls

Eisenberg (2005, p. 176) commented on the "*Unwillingness of charities to police their own activities*". The altruistic nature of charitable organisations often leads to the assumption that the people within them are honest and this negates the need for any form of control. As mentioned earlier, this is not necessarily the case and therefore there is a need for controls to improve transparency within charities. The battle to implement controls in charities was referred to by one interviewee:

People seem to think that, you know, you need to trust me, because we're all Christians that you don't need to ask me all the hard questions [if you trust me]. In a secular world, it is probably easier to say "right, show it to me" - you know, black and white? So ... when I start to ask the hard questions, it's like I

am very merciless. Don't you trust me? Or, why are you asking me for a receipt when I tell you it's \$10, it's \$10. It's all based on trust and it doesn't work. So that's the harder part of it, the questioning people about, you know, show me the proof, the evidence. (Interviewee 4 BA)

The issue of how to impose internal controls in French and Swedish charities was raised by Joannides (2007, p. 10), in relation to one of his interviewees, who said:

We are not seeking for quality, we are doing charity. How to impose the obligation of quality to good-will people?

Joannides (2007) found that church members strongly believed that goodwill and generosity or altruism cannot be controlled, which means internal controls are inappropriate as they will potentially damage the good will.

One of this study's interviewees felt this was just an excuse:

We do audits, but it had been a common saying within the Church, well God is our auditor. And so ... how can you go wrong because this is God's money. It is because it's a convenient excuse. It lends itself to huge abuse. (Interviewee 6 BT)

The need for internal controls was highlighted by England and Wales' Charity Commission (2009a, p. 13):

Allowing too much control to be in the hands of any one trustee is not a good idea for a number of reasons, but it can become a genuine threat to a charity's survival when there are insufficient checks, balances and financial controls in place, and sufficient accounting records are not kept.

The battle to implement internal controls appeared to be 'won' by one charity whose treasurer 'sold' internal controls to people within the charity as something to help them and to ensure that spending was related to the charity's constitution:

A lot of these systems, when I first introduced them, looked as though well you know, don't you trust us, and because I was the Treasurer at the time, I said look, I'm only doing this, [pause] one for the disclosures that you've been asking for, but I also wanted to protect myself. Other Treasurers before me had been blamed or [pause] been accused of using money inappropriately. (Interviewee 6 BT)

The summary of this section is best left to this interviewee who quite eloquently says:

To have that trust within the Church is good, to back that trust up with a system that complements it, and that's the way that I wanted them to see it, and that's the way that they do see it. (Interviewee 6 BT)

7.4 Summary

This chapter has identified several issues relating to fiduciary accountability in this research that also impact on transparency. Fiduciary issues were considered under

legislation and monitoring. Of particular interest in legislation was the fact that New Zealand's definition for charitable purpose does not include advocacy, which many within the charities sector consider an important part of a charity's role. There is a need for the Charities Commission to reconsider the limitation of charitable purpose into only four heads of charity, especially with many of the advocacy groups being refused funding due to them not being registered charities.

Another problem arose with regards to charities having similar names: this needs to be considered by the New Zealand Charities Commission when they next review the registration of charities to limit confusion by stakeholders. The ease by which charities can be established, and whether this is appropriate, will be considered in *Chapter Eight (section 8.4.5)*.

Attention was also given to the legal structure of charities and in particular whether companies and incorporated societies, with their shareholders and members, are appropriate legal vehicles for charities. There is a need to be transparent about the main aim of the business being its charitable purpose rather than satisfying the demands of their shareholders and members, and it is doubtful whether these legal structures meet this aim.

The final aspect of legislation looked at the need for charities to acknowledge the taxation benefits they gain and be accountable for justifying them, especially with regards to charities that have chosen not to register, such as an unregistered charitable trust.

Once again the issue of poor professional standards, raised in *Chapter Six*, was considered, this time in relation to Charities' Board members and charities' auditors. Well-meaning people may be constraining charities' ability to achieve their mission effectively by considering that they are 'giving to the community' by sitting on a Charity Board without experience, or by accepting audit roles without an understanding of the technicalities of risk-based auditing. These people must be up-skilled to lessen the potential harm done to the image and functioning of the charity.

The altruistic nature of charitable organisations often leads to the assumption that the people within them are honest and this negates the need for any form of control. This research noted the battle taking place in some charities as some interviewees attempted to implement internal controls, to the horror of those in the charity who considered they were not being trusted. There needs to be a balance between trust and internal controls.

To have trust is good but to support it with a system of internal control enhances that trust.

Of particular concern is the large number of charitable organisations who have chosen not to register and hence are not ‘caught up’ in the Charities Commission’s monitoring ‘net’. This gap in the monitoring of organisations that are potentially receiving taxation concessions and benefits needs to be addressed by the New Zealand Government, perhaps under the auspices of the Inland Revenue Department.

This study identified some serious weaknesses in the Charities Commission’s Annual Return, including the lack of care taken by some charities in completing their Annual Return. This was compounded by the fact that the Charities Commission has not yet incorporated any simple edit checks to highlight input errors.

Finally, another concern with the Annual Return was in relation to the Charities Commission using it to monitor compliance with charities’ charitable purpose. Given the lack of information relating to the achievement, i.e. outcomes, of a charity’s mission on the Annual Return, this is an issue. Performance accountability in terms of the reporting of financial information to stakeholders, in particular, reporting of outcomes, will be further considered in the next chapter.

CHAPTER 8: PERFORMANCE ACCOUNTABILITY

8.1 Introduction

The profusion of charities being established means there is a need for the donor to be able to distinguish between them to determine which ones to support. This is not only a New Zealand problem, but an international one. As Linda Polman notes in Anthony's (2010) article, there has been a large increase in charities involved in major humanitarian efforts, in 1980 40 charities were dealing with Cambodian refugees; by 2004, 2,500 charities were involved in Afghanistan. How can donors then choose which charity to support?

One way of informing this decision is through an assessment of charities' performance accountability. This chapter focuses on this issue, in contrast to *Chapter Six and Chapter Seven* which focused on the impact of financial accountability on charities (*Figure 8-1*).

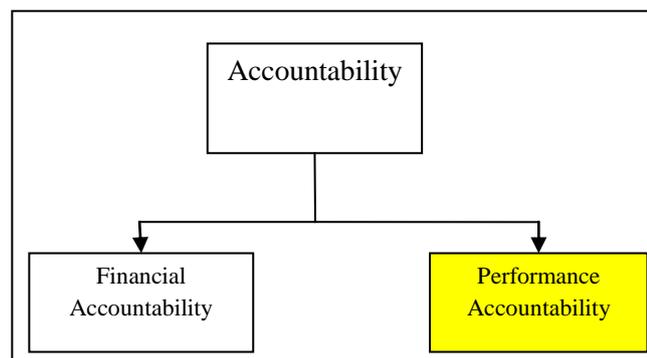


Figure 8-1 Dimensions of Accountability

Performance accountability for the 'for-profit' sector focuses on value creation, i.e. creating money for its stakeholders, particularly its owners (International Federation of Accountants, 2009b). This relationship does not exist in charitable organisations where donors and funders do not usually receive the benefit of the services the organisation provides. However, Connolly and Hyndman (2004) consider that there is a need for performance accountability in the charities sector to allow charities to justify their existence. They considered that unless performance measures are in place to achieve performance accountability, it is difficult for charities to counter criticisms of poor management and ineffectiveness. They went further in an earlier article (Connolly & Hyndman, 2003, p. 99) by saying that:

A lack of adequate performance accountability, particularly if it were highlighted in the media, could discourage potential donors.

Performance measurements give a visibility to the resources, activities and achievements of a charitable organisation, which leads to better informed discussions and decisions. Connolly and Hyndman (2004) also believe that the need to discharge accountability through the publication of performance information acts as a disciplining pressure and encourages management to concentrate on the issues that are of importance to their stakeholders (Connolly & Hyndman, 2004).

However, many authors vehemently oppose the imposition of any form of performance measurement on charities, including Riddell, who argued that:

The reason they [charities] exist is to respond to the cry for help from poor people and that it is wholly inappropriate – even morally wrong – to judge [charities] by the impact of the funds provided. (Ebrahim, 2003, p. 192)

This chapter will describe the current performance accountability focus on the measurement of outputs before moving on to how charities should be reporting to stakeholders i.e. a proposed framework for performance accountability. Finally, the chapter will consider possible future impacts if the proposed framework is followed, including possible impacts on funders and the role rating agencies could have in measuring and interpreting performance accountability.

8.2 Current Performance Accountability

This section examines the current emphasis on measuring charities' performance through output reporting. Output measurement focuses on determining what proportion of donations has been directly spent on administration and fundraising rather than directly spent on beneficiaries.

Two issues were identified in *Chapter Three (section 3.2.4)*. The first issue was what was the prevailing view regarding reporting separately the expenditure overheads ratio. This study found that many charities report expenses by nature, e.g. salaries, as reflected in Question 25 of the Charities Commission's Annual Return Form (Charities Commission, 2008c), rather than by function, thereby obscuring fundraising expenses.

The second issue was the question of whether the focus on reporting the expenditure overheads ratio separately was appropriate or whether emphasis should be placed on value given to beneficiaries. Before determining the problems with output reporting it is important to gain an understanding of what the term 'output' means.

In New Zealand both the Controller and Auditor-General (2008, p. 41) and the NZICA (2007b, p. 19) define outputs as “*the goods and services produced by the reporting entity*”. Outputs are reported in terms of what proportion of total operating expenditure relates to the beneficiaries of the charity, i.e. the total costs of services provided to beneficiaries (Institute of Chartered Accountants in Australia, 2009a).

This section reviews the problems associated with this form of performance accountability, including the reluctance to fund overheads. Next, the problems associated with this focus on overheads are analysed, in particular the difficulty in comparing expenditure overheads ratios.

8.2.1 Difficulty in comparing ratios

This focus on efficiency measures, in particular the expenditure overheads ratio of expenditure overheads to revenues, means that some charities have been accused by the media and donors of high expenditure on management and administration costs when their ratios are compared with those of other charities. However, as Dhanani (2009, p. 187) emphasised this can be misleading because charity ratios may differ significantly based on “*actual organisational activities and areas of need rather than the efficiency with which they operate*” .

The nuances of ratios are highlighted by the following interviewee:

It's very interesting how different a lot of the ratios are because of some of the unique differences of how that [charitable] organisation operates. You know little things like whether they own their own building or not make a huge difference to overhead costings. (Interviewee 18)

Joan Buchanan, a Charities Consultant, also highlighted the variability in ratios on Radio New Zealand by distinguishing between different fundraising motivations that could affect ratios, including: raising an awareness of the charity and its cause; or hiring someone to cultivate bequests when it could be more than ten years, depending on the circumstances of the donor, before that money comes in (Radio New Zealand, 27 August 2009). These differences were further highlighted by James Austin of the Fundraising Institute of New Zealand, who raised the example of the different expense incurred by charities needing to build their donor basis compared with charities with an existing donor base (Television New Zealand, 30 July 2009).

Another reason for the variability in ratios could be that the monies given were related to purchasing a product or service. For example - tickets sold for a charity dinner must cover the costs of providing the dinner before any monies are distributed to charities.

This is seen in the charity ‘CanTeen’ where 75% of their funds come from just two sources: (1) the selling of bandannas, where 60% is retained; and (2) the sale of Christmas cards, where only 30% is kept by CanTeen (Anonymous, 2008c).

Another reason for the difficulty in comparing ratios is due to the lack of uniformity (*Chapter Six*) in the presentation of financial information, meaning the ability to calculate these ratios is compromised as it is not clear how much money actually got to the beneficiaries, especially if charities showed their expenses by category, e.g. salary, rather than by purpose, e.g. fundraising (Television New Zealand, 27 July 2009).

In New Zealand, as a possible result of recent media attention given to Epilepsy New Zealand, which focused on the small proportion of donation that the charity receives from the Epilepsy Foundation, has seen a Member’s Bill proposed by Amy Adams entitled ‘Fair Trading (Soliciting on Behalf of Charities) Amendment Bill’. This bill focuses on professional third party collectors who are in the business of collecting funds on behalf of registered charities. It requires them to disclose to potential donors the portion of the donation retained by them if this is more than 20%.

There is an assumption that comparing expenditure overheads ratios provides potential donors with a recommendation on which charity to support. However, this section has highlighted some difficulties in comparing this ratio, in particular the lack of uniformity in the presentation of financial information. Next, the reluctance by donors to fund overheads is analysed.

8.2.2 Reluctance to fund overheads

A common perception of donors is that any money not going to beneficiaries is ‘wasted’. The media support this emphasis, with numerous articles focusing on the percentage of money spent on administration and fundraising (and therefore not going to beneficiaries). For example, an article in Choice Online Magazine in April 2008 (Anonymous, p. 1) reads “*How much of your donation is gobbled up by fundraising fees and expenses?*” Also, as shown in *Chapter Three (section 3.2.4.2)*, numerous studies have focused on how much money is spent on administration and fundraising as well as the importance that donors placed on this (Anthony, 1978; Ashford, 1986; Association of Fundraising Professionals, 2009b; Baskerville, 2006; Charity Finance Directors’ Group, 2003; Henderson, 2002; Palmer & Randall, 2002; Pro Bono Australia, 2009; Rees & Dixon, 1983; Senate Standing Committee on Economics, 2008). A Parliamentary Committee in Australia found that 84% of respondents did not know

what proportion of their charitable donation reached their favoured charity's beneficiaries, yet 94% considered it important to have access to that information (Senate Standing Committee on Economics, 2008). This compared with a New Zealand Charities Commission study which found that 40% of respondents want to ensure a reasonable proportion of donations got to the end cause, i.e. was not spent on administration and fund-raising (Charities Commission, 2008e).

The reluctance to support charities with high expenditure overheads ratios is not necessarily a good thing and could lead to poor administration of the charity (Hyndman & McKillop, 1999). The inference in the media is that spending on overheads does not constitute spending on the charitable purpose:

There's mounting concern that donors have no way of knowing how much of their money is going to the charity and how much is taken for so-called overheads and expenses. (Henderson, 2002, p. A2)

However, without an efficient office most charities could not achieve their aims. Several interviewees highlighted this, for example:

There's been a lot of bad press about administration fees. I think charities have created a rod for their own backs. There's an obsession about how much is your administration fee? Charities have sort of hamstrung themselves because they're so cautious about how much the charity has spent on administration rather than saying, 'it's not about how much we retain, it's how impactful we are'. (Interviewee 9 BM – emphasis added)

There is a reluctance amongst donors to provide general operating support, even when such funding is crucial to the operations and integrity of charities (Eisenberg, 2005). Hunter (2009, p. 2) has suggested that the charities sector is the only sector where:

People don't think they should pay fair market value for what they are buying. In order to do its job correctly, a charity needs more than simply the threadbare ability to 'run' a program.

There is a view that people involved in charity should all be voluntary. To achieve this, volunteers must be independently wealthy, earning another source of income or on a government benefit. This view does not take into account the growing professionalism of the charities sector including those professionals who are working in the charities sector as their full-time job and who bring business acumen into their charities, as seen in the following example:

A part of that administration expense, a big chunk is salaries and people assume that we're all doing this for the love of the job. We don't get paid what blue chip organisations do but I'll spin it on its head and say I'd rather have professional people and pay them solid salaries because they're custodians of \$15 million.

There is no point in me getting a volunteer in who can't do the job. No one wins in that case. (Interviewee 9 BM)

So what should a charity spend on administration and fundraising? No definitive answer can be applied to all charities, as differing ratios might be expected between grant making charities with relatively low overheads and service-providing charities that are likely to have higher overheads (Hyndman & McKillop, 1999). There is a need to move away from asking 'what amount?' to identifying 'what level of service?' charities need to support their work in changing beneficiaries' lives. Even Trevor Garrett, the Chief Executive Officer of the Charities Commission, was unable to answer the question of what was an appropriate level of spending on administration and fundraising:

Sometimes we forget to ask whether the charity is actually doing a good job, and how effective the charity is in achieving the ends that the charity was set up to do. And you know, sometimes I do worry when we have this debate about what the percentages should be because it's very difficult to work out what an appropriate percentage is (Radio New Zealand, 27 August 2009).

However, in this study the need for appropriate spending, including paying salaries and wages for charities' staff, was acknowledged by some interviewees who considered that relying on volunteers was not always the appropriate option:

You can't run an outcome driven event for the general public completely free of charge. You know, you have to operate in a professional environment where you're putting out credible information. So you've got to be a completely professional operation, and therefore there are professional costs associated with that. (Interviewee 16 BTM)

This issue of overheads is one factor that donors consider when they are donating, but consideration must also be given to other factors impacting donors' decisions about which charity to support: these are covered next.

8.2.3 Donating with your 'heart-strings'

Lumley (2009, p. 3) identified six reasons why donors make their decision to donate to a particular charity:

1. A personal connection to a specific charity;
2. A personal connection to a specific cause or issue;
3. A personal connection to the person doing the asking;
4. A resonance of personal beliefs or values with an issue or the field in which a certain charity may be working;
5. A sense, impression, or knowledge of a great need to be addressed; and
6. A 'brand loyalty' to or generalized confidence in a given well known charity

None of the above reasons includes any analysis of the charity's financial statements. In fact, further to Lumley's reasons is the ultimate view that donors rely on their 'heart strings' to choose which charity to support rather than attempting any evaluation of which is the 'best' charity to support, as shown by Holm (2009, p. C11) who said "*I have enough faith in people to assume most donations do good.*" This view was also supported by some interviewees:

The ones [charities] that are doing well are more marketing astute and know that they have to tell a story to gain the best ongoing support from their stakeholder group. There's another big benefit for them as they've got the ultimate marketing weapon because they've got something which is tugging on the heartstrings, they've got a good cause. (Interviewee 18 A)

Yes, it comes back to what the desire to support is. Before you reach into your wallet there's got to be an emotive need. People aren't that rational and clinical to say I'll look at all these financial statements. (Interviewee 9 BM)

This means that the charity that pulls most of the heart strings gets the most support. The negative side of this is seen in a book written by Linda Polman entitled '*War Games: The Story of Aid and War in Modern Times*' (Polman, 2010). In an article entitled '*Kindness kills when aid prolongs war*' journalist Anthony (2010, p. B10) reports on an example in Polman's book:

It's the visual image that sets the news agenda, and the more shocking the image, the more attention it gains, and the more attention it gains, the more aid it's likely to attract. For example: In Sierra Leone the rebels noted that they only received coverage from BBC World when [child] amputees emerged from the jungle.

Anthony (2010, p. B10) considers that when the next appeal comes with images of child amputees:

Most of us who care will neither look away nor dig a little deeper into the political background. Instead, we will get out the cheque book. Because while charity doesn't always benefit the intended recipient, it usually manages to make the donor feel better.

Trevor Garrett, Chief Executive Officer of New Zealand's Charities Commission, is concerned donors aren't using their 'head':

But I do worry that donors don't ask 'if I'm giving money to an organisation, is it actually helping anything? Is it achieving anything?' (Radio New Zealand, 27 August 2009)

There is a need to get the balance right between the 'emotive', i.e. heart, and the head, including the 'financially informed' aspects of the donating decision. As relying just on the heart could mean that any rumour of wrong-doing may tarnish a charity's reputation and lead to donors' trust in that charity being broken, even though there may be no

substance to the rumour. As Ken Berger, the Chief Executive Officer of Charity Navigator, said in an interview:

People typically give from the heart and if they don't use their head, their heart is going to get broken. (Social Solutions, 2009)

England and Wales' Charity Commission considers that a charity's reputation is a "precious commodity and losing it can impact not only on an individual charity but on the public's confidence in the charity sector as a whole" (Charity Commission, 2009a, p. 11). Thus if a charity's reputation is tarnished by bad media reports there would be an immediate impact on the level of donations. This was seen last year in New Zealand where it was widely reported that Epilepsy New Zealand had received only 2% of donations paid to one fundraising organisation - the Epilepsy Foundation (McCracken, 2009, 26 July). Epilepsy New Zealand had done nothing wrong, as they did not have control over the Epilepsy Foundation. Even through the Charities Commission investigated the Epilepsy Foundation and found no evidence of fraud, this did not improve Epilepsy New Zealand's reputation in potential donor's eyes (McCracken, 2009, 6 December). This led to Epilepsy New Zealand being forced to cut services due to a donor backlash, after the publicity led to a dramatic lowering of donations (McCracken, 2009, 6 December).

The need for balance when considering donation-making between using your head, by utilising financial statements or other useful information, and relying on the heart is highlighted by Ken Berger of Charity Navigator:

Sometimes a charity can provide you with a compelling story about what they do, but there may be little more than that when you look deeper. In other words, they have little or no evidence that they are truly helping others. (Berger, 2009, 19 October, p. 1)

This section examined the problems with donors just relying on emotive reasoning, i.e. heart-strings, in their donation decision. There is a need to balance this donation-making choice between the 'emotive' and the other aspects including the 'financial information' aspects of the donating decision. Part of this is achieved by ensuring that the financial information, in the form of financial statements, is as good as it can be, which is considered in the next section.

8.2.4 Financial statements 'don't tell the full story'

A phrase that has gained in popularity in the charities sector relates to the need for charities to 'tell their story'. The importance of this is seen by the New Zealand

Charities Commission publication '*Telling your story through non-financial reporting*' (Charities Commission, 2010c).

A particular limitation with charities' financial statements is its focus on inputs, of both funds and resources i.e. costs, rather than utilising the financial statements to tell the full story. If charities decide that their financial statements are the main tool for communicating with stakeholders, then it makes sense to ensure they are transparent and understandable. If charities don't focus on the financial statements, then the question arises; who really reads the financial statements? In New Zealand, the financial statements of charities were previously not widely circulated. This is no longer the case with the financial statements of registered charities being easily available on the Charities Register.

The limitation of financial statements can be seen in how charities report to their donors and funders. Often, charities do not send their regular donors their financial statements, but rather they send them a newsletter outlining stories of how the donors' money has made a difference, without supporting this with financial statements. This is highlighted by the following interviewees:

We have a quarterly kind of a newsletter we send. Now that is our regular communication with our donor base, and it will always carry information about what happened in the last quarter, things we did, the results. (Interviewee 9 BM)

There's no formal reporting on any kind of regular basis about that [financial information]. But five times a year a newsletter goes out that's very much more in a personal style, just talking about what's happened. (Interviewee 11 BTA)

The importance of using stories, rather than financial statements, to demonstrate what the charity is doing is supported by the following two interviewees, both in their charity role and their role as a donor to other charities:

When they [the charity] had a look at where the people were going [on their website], nobody was going to the financial accounts at all. They were all going to the stories of how people's lives had been changed and the good news stories and all those sorts of things. Nobody was interested in the financials. The financial statements don't tell the story of the organisation. (Interviewee 5 BA)

I am a contributor to probably a dozen organisations. I know the people, I know the organisations, I do receive their narrative and story based newsletters. I know what they're doing, and at the level I'm prepared to support. That's good enough for me. (Interviewee 11 BTA)

The use of newsletters and stories, rather than financial statements, to report to donors indicates that financial statements have become increasingly irrelevant when charities are reporting to their donors. As Interviewee 29 (MB) says "*you can't read much into a*

set of accounts” so there is a need to, as Interviewee 45 (BA) puts it, “*find ways through financial reporting to ‘tell the story’ of the charity*”.

If financial statements don’t tell or support the story of the charity, then charities are left with financial statements that don’t reflect the activities of the charity. This was seen in New Zealand, with the case of Kidscan, whose Chairman, in relation to their financial statements, stated on national television that “*there’s a huge amount of extra value that we don’t have to pay for that’s not received in our accounts*” (Television New Zealand, 12 August 2009). In fact Connolly and Dhanani (2009, p. 5) consider that charities’ financial statements play a limited role in discharging accountability as “*they provide little information about success, performance and impact*”.

It is encouraging to see some chartered accountants actively encouraging their charity clients to improve the quality of their financial statements as a communication tool, as seen in Hayes Knight’s client publication ‘Not-for-Profit News’:

It is important that your annual financial statements are telling your organisation's story; what you stand for, the good work you are doing, how well governed you are, how well you manage and use your scarce resources, what you want to achieve and why you need ongoing support to do this. (Hayes Knight, 2009, p. 1)

The Charities Commission’s recent publication (Charities Commission, 2010c) ‘*Telling your story through non-financial reporting*’ highlights the growing need for charities to report on the results of their work in terms of what difference the charity is making. This is a positive step by the Charities Commission, although, whilst the requirement remains voluntary, many charities may choose not to heed the publication unless it becomes a requirement or their donors start demanding it.

A study by Connolly, Hyndman & McMahon (2009, p. 12) found the value of reporting on achievements, especially by utilising the ‘story’ approach, where narrative explanations are used to support the financial statements. They went on further to say that there was a need to report on “*performance outcomes rather than merely outputs*”, which will be discussed next.

8.3 Proposed Performance Accountability Framework

Some of the limitations of output reporting as a measure of performance accountability were covered in the previous section, which highlighted the need to report on achievement, i.e. outcomes, rather than outputs. This section proposes a new way of reporting to stakeholders in a ‘three-pronged’ approach (*Figure 8-2*) which should

achieve an appropriate level of performance accountability for charities. Whilst many authors have proposed a move to outcome - rather than output reporting, this section will elaborate on the importance of having a third facet to performance accountability, that of financial viability, which represents the importance of charitable organisations continuing into the future (Ashford, 1986; Connolly & Hyndman, 2004; Grimwood & Tomkins, 1986).

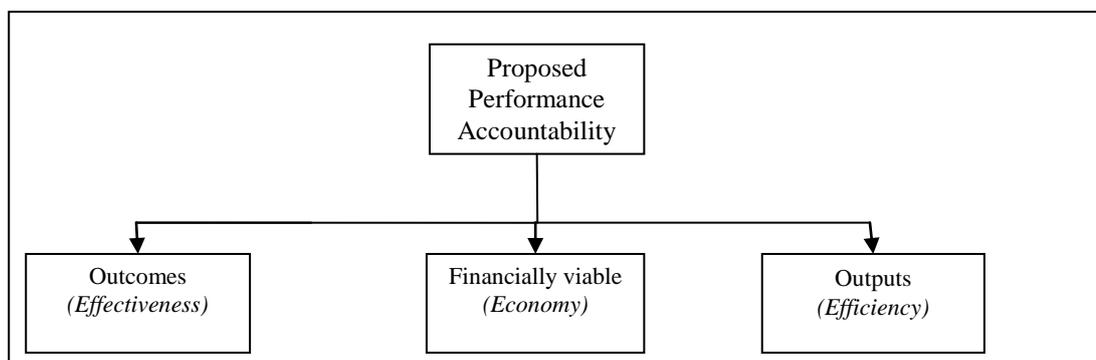


Figure 8-2 Proposed Performance Accountability Framework

This section will look first at the meaning behind outcome reporting. It will then consider the need for a charity to be financially viable, before finally addressing the need to engage with output reporting, despite its limitations.

8.3.1 Outcomes

Outcomes answer the question ‘*what difference does our organisation make?*’ (Snively, 2008, p. 7). A succinct definition could be: “*what good has it done the users?*”. New Zealand’s Controller and Auditor-General (2008, p. 40) provides a definition of outcomes based upon NZICA’s (2007b, p. 19) in TPA-9 Service Performance Reporting:

Outcomes refer to the state, condition, impacts on, or consequences for the community, society, economy, or environment resulting from the existence and operations of the reporting entity. (Controller and Auditor-General, 2008, p. 41)

Many donors and the media are focused on output reporting but there is a growing demand for charities to demonstrate that their activities are delivering ‘best value’, i.e. outcomes reporting both in New Zealand (Grant Thornton, 2008, 2009; Mueller et al., 2005) and Australia (Institute of Chartered Accountants in Australia, 2009a; Productivity Commission, 2009; Senate Standing Committee on Economics, 2008). In New Zealand this was recently highlighted by Trevor Garrett, the CEO of the Charities Commission, who said:

A recurring theme from many donors is will they be able to see compelling information and evidence about ‘their’ charity’s achievements. (Garrett, 2010, p. 2)

This focus on reporting the achievements of the charities in relation to their objectives is also seen in England and Wales where registered charities with income over GBP1 million now need to complete a ‘Summary Information Return’ (SIR). The SIR’s eight sections includes one on ‘The charity’s objectives and achievements’ where charities are asked to describe their main objectives for the year and whether they were achieved (Charity Commission, 2009e).

In this study the importance of reporting on the outcomes of charities’ activities was highlighted by the following quotations from interviewees:

The activities of the organisation are far more important than the financial statements (Interviewee 5 BA).

It [the charity] has to be accountable but it also has to be impactful.

(Interviewee 9 BM)

Your constitution is your objective, that is what you really need to be reporting on, whether you are achieving your objectives. (Interviewee 15 BM)

The most important thing is what the organisation exists for and how well it is able to meet its aims. The smart organisations that I see in the charities sector are the ones that integrate some outcome reporting within their financial statements. But they’re few and far between. (Interviewee 18 A)

However, although there is a growing demand for outcome reporting few, if any, charities are doing it. This was illustrated recently in the US where Ken Berger from Charity Navigator asked 200 charities they currently evaluate to send him information on their current outcomes – only 10% were able to provide meaningful outcomes reporting (Social Solutions, 2009).

As Molloy and Cordery (2009, p. 48) note “*lapsed donors rarely claim they couldn’t afford to carry on giving, but they often say they’ve lost faith in the effectiveness of their giving*”. This is supported by Lumley (2009) who considers that, rather than telling donors about overheads, charities should concentrate on what that administration cost achieves, particularly in relation to making a difference in the lives of charities’ beneficiaries, as discussed next.

8.3.1.1 Making a difference in beneficiaries’ lives

A particular emphasis in outcome reporting is in relation to beneficiaries, for whom outcomes can be defined as the change in their circumstances brought about by the outputs, or the immediate products or services generated by the charitable organisation.

In New Zealand, Joan Buchanan, a charity consultant, has noted that most charities are really trying to make a difference in peoples’ lives and just need to communicate this

more effectively in order to increase their donor base (Radio New Zealand, 27 August 2009). Her view is supported by Lumley (2009, p. 1), who states:

In order to demonstrate that it does deliver benefit to the people it's supposed to, and crucially to demonstrate that as much benefit as possible is being delivered, the charity must measure its outcomes for those beneficiaries.

Thus, it is essential that outcome reporting emphasises the changes a charity has made to its beneficiaries' lives. There is an assumption that these changes are positive, but this is not necessarily the case. Therefore, outcome measures need to be evaluated to ensure that appropriate information is reported and that charities are not trying to improve their results inappropriately, which will be discussed next.

8.3.1.2 The need to evaluate performance measures

Charities need to evaluate the effect that they are having on their beneficiaries to ensure this is positive. Some charities rather arrogantly consider that they know the effect is positive so there is no need for any evaluation, as Ken Berger, CEO of Charity Navigator highlighted in an interview:

One of the things that we hear [from charities] is "We know that we're having an effect, what do you mean that you want us to have to go through all of that craziness with collecting data and stuff?" (Social Solutions, 2009)

Pendlebury, Jones and Karbhari (1994) felt that any independent verification of charities' performance indicators, no matter what form it takes or who undertakes it, is going to add costs for limited benefits. They also thought there would be an inevitable emphasis given to measuring what is immediately measurable, rather than on what should be measured. This view was supported by Connolly and Hyndman (2004) who noted that if no verification of the outcomes is required there may be a temptation to present outcomes in a manner which is perceived as more acceptable to the reader, for example, by exaggerating good performance, regardless of its accuracy.

Although some charities may be able to deliver the best services without evaluating their results, the potential for harm to the beneficiaries is too great to risk not evaluating (Lumley, 2009; Natenshon, 2009). Charity Navigator finds that many charities consider tracking outcomes "*a burdensome drag on charities, diverting resources and attention away from the real work*" of charities and thus less than 10% of the charities they evaluate measure outcomes (Berger, 2009, 1 June, p. 1).

The need for evaluation can be clearly seen internationally. Even though international charities have spent over USD196 billion trying to improve the health of people in poor countries, there has been minimal evaluation done on the impact, so it is not clear what

the world has got for its money. The World Health Organisation, has done some evaluation, that shows some charities' programmes have actually hurt healthcare, but no changes have been made. Philip Stevens, from the International Policy Network based in England, spoke for many when he said:

The public health community has convinced the public that the only way to improve poor health in developing countries is by throwing a ton of money at it (Anonymous, 2009, p. A21).

The reason many charities give for not evaluating outcomes is that it is too hard to measure them, a point which is considered next.

8.3.1.3 Difficulties in measuring outcomes

Hyndman (1991) considered that the reason many charities did not report their outcomes was the difficulty in measuring these outcomes. More recently, this has been supported by Lee & Fisher (2007) who found that outcome measurements were difficult, particularly when the expected impact on beneficiaries is often influenced by external environment factors which are outside the control of the charity.

The fact that financial reporting occurs annually presented more difficulties, as noted by Aimers & Walker (2008), who found that it is difficult to demonstrate an immediate impact from the services of many charities since the intended effects may not be apparent for several years. Agyemang et al. (2009, p. 22) also found that the short term reporting requirements of donors did not consider the slow local decision-making processes of some beneficiary communities, who did not necessarily stick to reporting deadlines.

Given the difficulties in measuring outcomes, charities tend to use those measures which are easy to compile rather than the most appropriate measures, which limits the success of outcome reporting in providing meaningful information (Agyemang et al., 2009; Lee & Fisher, 2007). This further emphasises the need for outcome measurement to be evaluated to ensure that it is the best form for measuring what difference the charity makes in the lives of their beneficiaries.

Before leaving outcomes performance measurement and moving on to the reporting of charities' financial viability, it is useful to look at the five reasons Sorkin (2009) identified for charities not measuring, evaluating and reporting on their outcomes. These are: (1) Ignorance of how to do it; (2) Fear of what they might discover; (3) Lack of resources to do it; (4) Lack of commitment to doing it; and (5) Conscious resistance to doing it (Sorkin, 2009). Even with all these difficulties, the consideration of whether

beneficiaries' needs are met is an important facet of a charity's future survival and must be addressed. This is succinctly stated in the following quote from Ken Berger, the Chief Executive Officer of Charity Navigator:

We must get past the notion of doing 'good work' with no accountability. We must get past the idea that nonprofits are too complex or unique to be measured. The [charities] sector must get its act together and make sure it is really helping provide meaningful change in communities and peoples' lives. It is life or death for many of those we serve whether we are effective or not (Berger, 2009, 1 December, p. 3).

However, the final word is perhaps best left to an actual example of the focus some charities put on their activities and measuring how they impact on their beneficiaries' lives. In New Zealand, Barnardos, a children's charity, consider that:

Our primary purpose is not about making a profit or just about the number of children and families we work with. It is not even the quality of our services. Rather, the primary purpose is about knowing that we are making the maximum possible difference in the lives of New Zealand children. We are hoping that this [outcomes reporting] will provide us with much more meaningful information about the true difference achievable in the lives of children and families. (Edridge & Lawless, 2007, p. 59)

8.3.2 Financial viability

As seen in *Chapter Six section 6.5.3*, charities are particularly concerned with how donors and funders interpret their having a surplus (Clement, 2010). Some donors and funders interpret a reported surplus as indicative of the charitable organisation not needing further funds (Hayes Knight, 2010). However, this overlooks a charity's need to be financially viable (Newberry, 1992, 1995b). Charitable organisations are concerned that, in order to receive funding, they need to demonstrate financial distress, which could be argued to be irresponsible to their beneficiaries by being too short-term rather than providing long-term stability (Newberry, 1995b). This emphasis on 'looking poor' was recently highlighted by Hyndman (2008), who referred back to Bird and Morgan Jones' (1981) statement that still holds true today:

Management is fearful that if it reports truly and fairly, its fund raising activities will be adversely affected and therefore ways and means are found for tucking away revenue and charging expenses which would not be tolerated in business accounts. This results in an understatement of the surplus for the year or an overstatement of the deficit. (Bird & Morgan-Jones, 1981, p. 196)

This New Zealand study found that several interviewees demonstrated a reluctance to have money sitting around because this makes them look cash rich:

We sold the building and ... I just invested it in the [bank]. Well that didn't look good on our books. Every time we went for a grant application, 'well why aren't you spending your \$300,000 on this?' (Interviewee 15 BM)

Because of the way people look at your financial statements, if you left it [money] in the organisation, at one level some people will say 'oh good, you're nice and secure we'll invest'. Whereas other people are going to go 'oh, you've got all that money you don't need any'. (Interviewee 20 B)

Some of our committee don't want money sitting in the bank, because they actually feel that [when] the funders see that, they're not going to like it. (Interviewee 21 MT)

If you've got too much money they [the funders] tend to turn you down. If however you've got a Trust, you can sit some of your funds across there and you can apply for funding while legally not showing the full amount of funding that you have available to you. (Interviewee 29 MB)

Donors must be persuaded that the charity is using its funds to provide worthwhile charitable services and that it is in need of additional funding (Bird, 1985). Connolly & Hyndman (2003) considered it should be reasonable for charities to seek a small surplus to support future plans and provide a degree of sustainability, since an important aspect of a charity must be to continue on into the future. This was recently supported by Helson (2010) who considered that financially viable charities need a 'rainy-day' fund so that in the event of an economic downturn they could still keep their charity running into the future. Some interviewees in this New Zealand study did consider it important to set monies aside in a reserve to 'safeguard' the future of the charity or for a particular future need such as building maintenance:

One of the things that really upsets me is we cannot budget at all. On April 1, all I know is that I've got \$32,000 income [to fund \$150,000 expenses]. Well, it's nerve wracking because we have salary commitments - there's people whose lives depend on having a salary. And I don't know where it's coming from. That's why we need to get reserves set up. (Interviewee 15 BM)

I've still not set my budget, which is a huge cause for concern. Because of the age of the building, I want to clearly separate out some expenditure that we can put aside, so that when the roof needs replacing we don't suddenly go 'oh' [we can't afford it]. (Interviewee 21 MT)

The amount to 'set aside' depends on the charity's reserve policy. Helson (2010) considered that six months' operating expenses set aside would be sufficient to sustain a charity through financial tightening of donor support. Some interviewees in this study had different ideas, however, including:

I said to the Board that we should hold under investment no more than three and a half times our average [annual] expenditure. If we have a couple of bad years, we've still got enough funds to actually get the organisation going and carry out the charitable activities. (Interviewee 12 MA)

I was taught in [name of charity] that you should have, 3 months worth of salary in the bank (Interviewee 21 MT)

As well as setting aside reserves, another way of showing financial viability on a charity's financial statements is by fund accounting (*Chapter Six, section 6.4.1*) and in particular separating funds into restricted and unrestricted categories so there is a clear indication regarding how much of the unrestricted fund a charity could 'freely' use to remain financially viable (Connolly et al., 2009).

An acknowledgement of the importance of financial viability is seen in the recent publication of the Charities Commission's '*Telling your story through non-financial reporting*' (Charities Commission, 2010c, p. 2) where one of the ten questions asked is "*Is your charity sustainable?*". This question is further elaborated by "*Who funds you right now? Why do you need more money?*" These are very simple questions, and a small step in the right direction. More directed information is provided in England and Wales. There, the Charity Commission's SIR's includes a section on '*The charity's financial health*' where charities are asked to describe their financial health for the period (Charity Commission, 2009e, p. 3). This is also considered important in the US, where there has long been a requirement to provide information to determine whether current-year revenues are sufficient to pay for current-year services (Governmental Accounting Standards Board, 1987).

The conflict between on the one side wanting to show the 'correct' result, which shows the charity is financially viable, compared with not wishing to lose funding is noted in Parker's (2003, p. 372) case study on a charity:

[The charity] felt caught in a trap between wanting to be open and accountable to key stakeholders, but at the same time fearing potential sponsors and donors reducing support when informed of Servo's major assets. Yet the Board firmly believed that such an asset base was an essential infrastructure required to meet the growing community demands for social welfare services.

It is a concern that charities are faced with this conflict, since financial viability is an important measure of accountability as it is important that a charity is financially healthy so that it does not "*falter in the long term*" (Social Solutions, 2009, p. 7). However, Fisher (2009, p. 65) noted that several charities were not concerned about their finances:

It still horrifies me how many NFP organisations [including charities] do not have a good handle on their basic finances. Or they get their financial information so late it is essentially useless. They must get this area sorted, or get prepared to shut down.

It is important not to focus solely on financial viability without considering whether the charity is efficient, as well as effective. Next, the importance of balancing output

reporting, outcome reporting and financial viability as part of performance accountability, is investigated.

8.3.3 The enduring importance of outputs

Even given the limitations identified earlier in this chapter (*section 8.2*), there is still a place for output reporting in a performance accountability framework. This is particularly so in relation to fundraising charities that have no direct link with the beneficiaries of the charitable activity, but are conduits through which monies pass from the donor to the service-providing charity. In this case, output measurements are important and necessary. This is evidenced by recent New Zealand examples profiled in the media, including the Epilepsy Foundation, which collected monies on behalf of Epilepsy New Zealand, but passed on only 2% of what was received (Television New Zealand, 27 July 2009).

Internationally, the requirement for output reporting is intended to ensure that efficient means of achieving real difference in beneficiaries' lives are achieved, rather than donations being directed towards funding an unnecessarily large number of administration staff. Philip Stevens, from the International Policy Network based in England, spoke for many when he said "*It is perhaps not coincidental that thousands of highly paid jobs and careers are also dependent on it [charitable funding]*" (Anonymous, 2009, p. A21). Two of the worst cases of monies not being used for the benefit of the beneficiaries in recent times involve Afghanistan where "A US funded road leading to the Kabul airport was built for US\$3.7 million per mile (1.6km), four times the average cost of most roads in the country" (Anonymous, 2008d, p. B1), and East Timor, where as little as 10% of donations was used for the intended purposes and, even worse, as little as 5% of the United Nation's mission budget, was spent in East Timor (Deutsch, 2009).

A key theme from the UK government's 'The Private Action, Public Benefit' report published in 2002 was the need "*to get charities to focus much more on their outputs and outcomes as a basis for performance management and better accountability*" (Hyndman & McMahon, 2010, p. 10). Several authors agreed with this focus on outcomes and outputs (Ashford, 1986; Connolly & Hyndman, 2004; Grimwood & Tomkins, 1986). However, this focus does not ensure the charity's survival into the future, i.e. the financial viability of the charity, which is of great importance to enable continuing improvements in their beneficiaries' lives.

The important aspect of the proposed performance framework is that all three facets are needed, i.e. outcomes, financial viability and outputs. As can be seen from the Afghanistan and East Timor examples, charities may be financially healthy but that doesn't necessarily mean their donations are being spent wisely to aid the beneficiaries (Social Solutions, 2009).

Finally, the possible future impacts of the proposed performance framework will be considered, including the potential impacts on funders and the need for rating agencies to interpret the additional information provided by charities.

8.4 Possible future impacts

The possible future impacts of a broadening of performance accountability to encompass both output, outcomes and financial viability reporting could see many impacts. This includes the impact on funders' reporting requirements and the need for the Charities Commission to adjust its Annual Return form to better reflect the impact the charity has had on its beneficiaries. There may also be a need for rating agencies to interpret all the information for donors to enable them to make an informed decision.

Other potential impacts could be a broadening of the Charities Commission's registration requirements beyond the current focus on whether the organisation has a charitable purpose, to one of sustainability. However, the success of any proposed broadening of performance accountability will only be possible if there is uniformity in measurement. Prescribed performance reporting standards will be necessary to achieve this. First this section will look at funders' current and potential future reporting requirements.

8.4.1 Funders

As discussed in *Chapter Two section 2.6.3*, there is a wide variety of funders, both governmental and non-governmental, providing funding to New Zealand charities. This section looks first at the current reporting requirements of funders to the charities they fund. For the broadening of performance accountability to be successful there is a need for funders to broaden their future reporting requirements to incorporate the three facets of future performance accountability. First, funders' current reporting requirements are considered.

8.4.1.1 Funders' current reporting requirements

Chapter Two section 2.6.3, highlighted the three reporting requirements demanded by the funders of charities and some of these requirements were also discussed by interviewees. First, funders usually want to see their contribution shown separately in the financial statements, which some interviewees resented:

You've got to show funders who gave you the money that you acknowledged it in some way. So you've got to have the big list and the annual report to show that you've shown it and that you've shown what it was for so that you haven't just taken their money. (Interviewee 14 MA)

Funders wanted to know not only how we were going to manage the money, which is fine, but they also dictated how we were to report it. That didn't sit well with me. (Interviewee 13 BA)

Second, funders require verification that funds are spent appropriately or, as Interviewee 14 succinctly states, “they want to see the proof that you've spent the money”. Another interviewee elaborates:

Once we [the charity] have spent it, we have to show them [the funders] proof of the invoice that we've received. Plus, we have to photocopy our bank account to show that the cheque has left our account. (Interviewee 16 BTM)

The third requirement involves charities needing to complete funders' special reporting requirements, including special reporting forms. Some of the forms that funders require are very detailed and some charities feel that the time taken to complete the administration requirements for monies received (to satisfy funders) can cost more than the money received:

I mean, you know, you look at something like that [given \$200 by funder] and you think oh gosh, why would you bother? So, I just sent them the cheque and refunded it. Oh, for goodness sake, I've got better things to do frankly. (Interviewee 14 MA)

Connolly et al.'s (2009) study also found that funders often misinterpret the financial statements of charities and do not understand them, so they ask for the information in their own format. This lack of understanding was confirmed by one interviewee:

Part of the challenge that I've had with dealing with funders is often the technical competence of the people who are making the funding decisions. Often times they don't have a great deal of financial background and experience and you know, no disrespect to them, but you're getting someone to read and analyse a set of financial statements who is missing some fundamental concepts in terms of what a set of financial statements actually is. (Interviewee 18 A - emphasis added)

Most funders appear not to be interested in seeing if money has made a difference to the beneficiaries, but rather focus on verifying the amount paid and whether it was within their funding requirements, as highlighted by the following interviewee:

Mostly they [the funders] are working to a trust deed which says we will donate to these criteria and they're looking to make sure they're working within that Trust deed. (Interviewee 18 A)

With funds drying up and the needs of charities becoming even greater, funders must be concerned with providing funds only to those charitable organisations that can demonstrate impact and effectiveness. As Sorkin (2009, p. 1) says “A dollar given to an ineffective organisations is a dollar wasted that could have been given to an effective organisation”. This will mean a change in funders’ reporting requirements, which is examined next.

8.4.1.2 Funders’ possible future reporting requirements

Society and the people within it are generally resistant to change, and for performance accountability to change there needs to be some impetus in order for change to happen. With the charities sector the change driver has to be large funding bodies for, as Sorkin (2009, p. 2) starkly puts it “as long as funds can be secured the old fashioned way by telling a sad story, why should charities go through the hard work of managing their performance?” Thus, if funders use their collective power to ensure that both reporting of outputs and outcomes, and proof that a charity is financially sustainable are required to secure funding, the world will change and outcome measurement will become ubiquitous (Lumley, 2009).

The need for change was seen in the US by one charity, the Latin American Youth Center, which changed its reporting to encompass outcomes reporting because:

We also saw coming down the road a change in reporting requirements from a variety of funding sources that were going to require more outcomes focused reporting. (Social Solutions, 2009, p. 14)

This charity considered that, if they could prove themselves effective in their work and be able to compare that to other charities, it would make them more attractive to funders. This has indeed proven to be the case (Social Solutions, 2009).

The awareness of the need for change is seen in New Zealand by one large funder, the ASB Community Trust, whose Chief Executive Officer said:

Increasingly we're going to be directing our funding towards organisations that can actually demonstrate they're effective. Now that may well mean that on top of our normal grants we have to fund an evaluation component. (Radio New Zealand, 30 August 2009 - emphasis added).

In previous sections the importance of the three-pronged approach to performance accountability was examined. One way of this broader approach to performance

accountability being successful is for funders to prescribe reporting requirements that incorporate all three facets. Another way is the introduction of rating agencies that ‘rank’ charities using all three facets of performance accountability.

8.4.2 Rating agencies

In the media there are been articles that, rather than sensationalise charities’ expenditure overheads ratios, provide readers with some useful analysis of what to look for when choosing which charity to support. In particular Reed’s (2008, p. 8) article identifies several questions to ask:

When you give to charity, you want to know your money will be spent wisely. Basically, asking the questions: what was the benefit to the community? How did it impact the beneficiaries who went through it? And then checking to make sure the money was spent the best way possible.

However, many donors may lack the ability to be able to answer these questions, so perhaps it is best left to rating agencies such as BBB Wise Giving Alliance, Charity Navigator and GuideStar to provide an answer. As detailed in *Chapter Two section 2.6.4*, rating agencies provide donors with objective third party data that donors can use to assess to whom they should donate (Social Solutions, 2009).

Just as funders need to change their reporting requirements, so too do rating agencies. Up to now they have focused on financial health in relation to outputs, i.e. efficiency, which, as discussed previously, can provide a narrow view of charities. The limitation of such a narrow focus was clearly seen in Tinkelman’s (2009) analysis of Avon Product Foundation’s breast cancer walks. These walks did not meet the BBB Wise Giving Alliance guideline of spending no more than 35% of donations on fund raising (BBB Wise Giving Alliance, 2003). Thus, Avon decided to cut back on fund raising expenses and in 2002 dismissed the organisation that ran the walks on its behalf. The net result was that charity donations from the walks fell from USD145 million in 2002 to USD27 million in 2003, but Avon now met BBB Wise Giving Alliance’s guideline. This was very unfortunate and if the rating agency had focused on outcomes rather than ‘efficiency’, potentially more beneficiaries’ lives would have been changed with the USD145 million compared with the USD27 million.

Gordon, Knock & Neely (2009, p. 482) supported the move to include outcome data on the impact or accomplishments of charities but considered that this was not practical as “no one has found a way to measure and report on effectiveness and quality of services”. However, Charity Navigator is looking at broadening their evaluation system

beyond financial health to include “*accountability (including transparency) and outcomes*” (Berger, 2009, 1 June, p. 1). Charity Navigator is starting to rate charities on their outcomes by examining a set of indicators that charities will establish and reporting on the achievement, or otherwise, of these targets (Natenshon, 2009).

This is a positive move, but the first step for New Zealand is to establish a rating agency for charities registered with the Charities Commission. It is possible that Charity Navigator may be interested in starting here, as one of the interviewees said “*You know we’ve just heard noises that it [Charity Navigator] is coming here*” (Interviewee 9 BM). However, at the time of writing this development could not be confirmed.

The establishment of an objective rating agency in New Zealand would be a boon to donors and funders alike and such a move is supported by Philanthropy New Zealand (2006). Until that time, it would be helpful if media and charity commentators could agree not to publish any more expenditure overheads ratios but publish outcome measures instead – although this is unlikely to eventuate. Next, the need for the Charities Commission to consider changing their Form 4 Annual Return (Charities Commission, 2008c) to better reflect the wider, performance accountability framework, is discussed.

8.4.3 Charities’ Annual Return forms

Disclosing performance information is an important part of the process of discharging performance accountability in charities. Currently, the New Zealand Charities Commission’s ‘*Form 4 Annual Return for a charitable entity*’ has limited performance information. As one interviewee highlights:

Annual Return forms for registered charities require much financial information [in question 25], but little about whether the charity is achieving its mission [outcomes]. (Interviewee 25 M)

For performance accountability to be successfully implemented throughout the charities sector, it is important that the New Zealand Charities Commission, as well as funders, require charities to report performance information across all three facets i.e. outcomes; financial viability and outputs. This widening of reporting is of particular importance given the Accounting Standards Review Board’s proposal to require simple financial and non-financial reporting for publicly accountable organisations such as charities, as part of the review of the Financial Reporting Act 1993 (Accounting Standards Review Board, 2009).

At the time of writing, the ASRB supports the ‘*Statements of Service Performance*’, as promulgated by NZICA in Technical Practice Aid (TPA) 9 (New Zealand Institute of Chartered Accountants, 2007b). TPA-9 provides guidance in relation to the specification, measurement and reporting of service performance. Reporting ‘service performance’ is defined as “*reporting the extent to which desired results have been achieved*” paragraph 5.1 (Audit Office, 1988 paragraph 5.1).

However, there are other formats that could be utilised for performance reporting including the Charity Commission in England and Wales’ ‘*Summary Information Return*’ which has a particular section on reporting outcomes (Charity Commission, 2009e). Some interviewees were keen to follow the public sector in preparing Statements of Service Performances, but Interviewee 18 (A) proposed a ‘*Statement of Resources*’ which used to be mandatory for New Zealand schools:

A statement of resources was designed to capture the other things that it took to run a school that may not be financially captured. For example, there are this many teachers, we have a volunteer base of three hundred. The average volunteer puts in this amount of time per year. We think, [based] on the average wage, if we had to pay for these people it would be this amount. (Interviewee 18 A)

The New Zealand Charities Commission needs to consider which form, if any, would be appropriate to broaden the focus of the Annual Return from accumulating information about the sector for stakeholders, in particular Statistics New Zealand, into emphasising the activities that support the charity’s mission. Whichever format is utilised it must be easy to complete and of high quality. The Controller and Auditor-General consider that good quality performance reports must:

Have a clear format and layout; be presented within the context of the reporting entity’s strategic objectives, past performance, and current. Show clear, logical, and easy-to-follow links between entity-level objectives, outcomes, outputs, performance measures, and performance targets; be clear and concise in their content; and be easy to read, expressed in plain English, and use words and terms suitable for users (with adequate explanation of acronyms, jargon, and technical terms) (Controller and Auditor-General, 2008, p. 48).

It is important that the Charities Commission is proactive in implementing changes to the Annual Return form so that prospective donors visiting the Charities Register will be able to access information on how charities have made a difference in their beneficiaries’ lives. Waiting for the relevant changes to the Financial Reporting Act to be enacted could take some time and change is needed now not in the future.

8.4.4 Prescribed performance reporting standard

Whichever performance reporting format the ASRB decides to propose in the amendments to the Financial Reporting Act, there is a pressing need to implement performance reporting standards. This was highlighted in England by Connolly & Hyndman (2003, p. xix) who argued that “*without the provision and promotion of specific charity-focused guidance.... The present limited state of performance reporting by charities will continue*”.

This issue was more recently raised in New Zealand by the Auditor-General who said:

There are no reporting standards in New Zealand for non-financial performance statements. Therefore, every entity needs to prepare and customise its own framework and the elements (primarily outcomes and outputs) within that framework to reflect its own nature (Controller and Auditor-General, 2008, p. 12).

For performance reporting to be successful it is essential that ‘easy to follow’ performance reporting standards within an appropriate reporting framework are developed to ensure consistency between charities.

8.4.5 Registration of charities

As discussed in *Chapter Seven* section 7.2.1, the Charities Commission’s key concern when registering charities is whether the charity meets the definition of charitable purpose, as set out in the New Zealand Charities Act 2005, section 5. There is currently a profusion of charities which sometimes overlap with each other in terms of their charitable purpose, since people sometimes establish a new charity rather than working with an existing charity. The New Zealand Minister for Social Development and Employment, Paula Bennett, has recognised this profusion and, perhaps as a precursor to merging, wants charities to start working together:

We hear all the time that [charitable] organisations are so busy and yet the one down the road isn’t as full [pause] so we just want them [charities] to start talking to each other more (Radio New Zealand, 30 August 2009).

My suggestion is that the Charities Commission should consider broadening its registration criteria to assess whether charities have the capability to deliver their proposed service or product in support of their charitable purpose before granting registration. This would be similar to what New Zealand universities need to do in order to have a new programme of study approved by the New Zealand Vice-Chancellors’ sub-committee on University Academic Programmes (CUAP). In New Zealand consensus must be reached amongst the eight New Zealand universities before approval is given for a new programme of study to be implemented. CUAP co-ordinates this

inter-university course approval, which has three requirements (available <http://www.nzvcc.ac.nz/aboutus/sc/cuap>) that could be appropriately adapted for charities:

- Acceptability of the programme: that the proposed course of study is acceptable to the relevant academic, professional and other communities. In relation to charities this would be liaising with appropriate experts in the charitable purpose area including existing charities;
- Resources: that the university has the capacity to deliver the course with regards to appropriate staffing, physical resources and support services. In relation to charities this would mean ensuring sufficient staff, both paid and unpaid, are available to cover the delivery of the charitable purpose and the administration of the charity. Also there is a need for appropriate and sufficient funding sources with expert assistance available as required, including accountants and auditors; and
- Evaluation and review: that the university has adequate and effective evaluation and monitoring procedures for ensuring the programme meets its objectives and should continue to be offered. In relation to charities this would ensure that an effective governance structure was in place as well as appropriate levels of: professional (*Chapter Six*); fiduciary (*Chapter Seven*); and performance (*Chapter Eight*) accountability with an evaluation process for all performance measurements, particularly outcome reporting.

New Zealand has a large number of charities pursuing an ever-dwindling charity dollar, and with limited numbers of people prepared to work in them. As the sector matures into the new era of increased transparency through the Charities Register, there will need to be a natural attrition of charities that are not effective. Otherwise, with no current limit on taxation rebates, the New Zealand tax payers are effectively funding charities that may not be meeting beneficiaries' needs and may in fact be doing more harm than good.

8.5 Summary

In their increasingly difficult pursuit of ever dwindling donations, charities will need to be proactive in convincing potential donors and funders that their charity is needful and deserving of financial support. One way to do this is for charities to use performance accountability tools to: justify their spending, i.e. output reporting; demonstrate the

impact they have on their beneficiaries, i.e. outcomes reporting; and prove their financial viability into the future.

This broadening of performance accountability tools should lead to changes in the reporting demands from funders and also could lead to the introduction of New Zealand rating agencies to evaluate the wider range of information provided by charities to donors who may not have the skills necessary to interpret it.

The importance of a broader approach to performance accountability in the charities sector is signalled by Charity Navigator changing their evaluation systems away from focusing solely on financial health to a rating that reflects outcome reporting. Such an approach will ensure that accountability does not detract from, but rather supports, the missions of charitable organisations.

CHAPTER 9: CONCLUSIONS & CONTRIBUTIONS

9.1 Introduction

Globally the charities sector is becoming recognised as playing an important part in communities by furthering governments' social objectives through increasing support to disadvantaged members of society. This is also the case in New Zealand where the Government considers that the charities sector assists them in furthering their own social objectives through, for example, increasing support to disadvantaged members of our society.

Accountability is seen as important for the charities sector in maintaining faith and ensuring the confidence and financial support of the public by giving an account of charities' activities. For accountability to be successful it needs to be appropriately discharged through accountability mechanisms. Financial statements are one form of an accountability discharge mechanism.

Access to charities' financial statements has recently become possible in New Zealand due to the development of a Charities Register. However, the ability to discharge accountability through financial statements also depends on financial statements being transparent and understandable which, as discussed in *Chapter Three*, is not currently the case. This research aimed to clarify the reasons for the different accounting treatments that impact transparency and understandability in relation to four complexities; accounting basis, valuation of PPE, fund accounting and the expenditure overheads ratio. The focus of this study was on gaining an understanding of 'what' accounting treatments charities have for each of the complexities mentioned and more importantly 'why' charities chose these particular accounting treatments.

For this research participants were: (1) people involved in the preparation or auditing the financial statements of charities; (2) managers of charities; (3) board members of charities; and (4) experts in charities. Rather than individual voices some interviewees were in groups which lead to a total of eighty-four participants who were involved in seventy-five interviews that sought to determine the complexities with transparency and understandability in charities' financial statements.

Accountability theory was used to guide the data collection and analysis. A proposed framework incorporating financial and performance accountabilities was developed that highlighted that accountability discharge mechanisms included not only financial

statements, but also other mechanisms including performance reports and rating agencies.

This chapter summarises the findings of this research and identifies its contributions before looking at opportunities for further study. Conclusions about the research questions will be reviewed next.

9.2 Conclusions about research questions

This research identified a gap in the literature around not only what accounting methods were used but why those methods were used. This study determined that there were three key reasons behind the choices charities make: (1) poor professional standards shown by accountants who work in the charities sector; (2) low level of financial understandability by people working or volunteering within charitable organisations as well as prospective donors and funders; and (3) a perceived need for charities to look ‘poor’ so as to attract funds. These will each be addressed in turn.

In relation to poor professional standards, this study found several instances where accountants did not keep current with GAAP and relied on their experience rather than utilising current accounting principles. This lack of compliance with GAAP has gained national attention through the media, which have exposed charities who have not been valuing donated goods and services in their financial statements.

This study also found a low level of financial literacy amongst preparers of charities’ financial statements. This lack of understanding within charities must be addressed to ensure charities produce meaningful financial statements that can be utilised for decision making.

Finally, the emphasis on ‘looking poor’ was a result of funders and donors preferring to fund charities that ‘need’ the funds rather than charities that are financially viable which lead to charities actively lowering their assets or income in their financial statements.

Next, the specific research questions relating to each of the four complexities of charities’ financial statements will be reviewed, starting with the accounting basis.

9.2.1 Accounting basis

The media’s emphasis on reporting the percentage of money received, from that pledged, severely impacts the public’s understanding of donations, which become

confused with pledges. Contrary to reports in the media, charities adopted a cautious approach in relation to the certainty of receipts as several interviewees considered that a pledge is just a promise so there was no certainty that it would be received. Hence, pledges were not recorded until received, as charities wanted to be transparent in their recording of revenues. This research highlighted that in order to be transparent there was a need for not only charities but the larger NFP sector to deal with issues of certainty of receipts, e.g. bequests, on a case-by-case basis to ensure organisations are accountable to their stakeholders.

There were two views in relation to the matching concept and both relate to transparency. The first view considered that it was a useful tool to utilise, especially with regards to projects spread over more than one financial year. However, the other view was that the charity should be proud to show how much funding it has received for the year. However, the key reason for the choice of method appeared to be the focus on 'looking poor' rather than being transparent. There was also an impact on understandability as the matching concept, with its ability to spread income over several years, was utilised if interviewees were aware of the concept, in order to 'look poor'. Next, the complexities of PPE are reviewed.

9.2.2 Property, plant and equipment (PPE)

Chapter Six determined that there was limited transparency with regards to PPE that was donated, as many charities did not record these PPE. The main reason for not recording was that the charity did not want to look 'rich' by having too many assets. For charities willing to record donated PPE at 'fair value' there was little understanding on how to measure 'fair value' as there was limited guidance from GAAP and hence the methods of valuing varied considerably. Until GAAP provides specific guidance on how to 'fair value' different types of PPE this situation will continue to impact transparency and understandability.

This study also highlighted a lack of understanding of depreciation by several interviewees who considered that depreciation was a capital replacement reserve rather than the operational cost of using the PPE, i.e. the 'wear and tear' of the PPE or the writing off of PPE over its useful life.

Both of these situations impact on the transparency and understandability of the financial statements of charities and this focus on looking poor limits the ability to

compare different charitable organisations as at times the PPE not recorded can be substantial. Next, the complexities relating to fund accounting are considered.

9.2.3 Fund accounting

The specific research questions relating to fund accounting were: how funds were recorded in the charity's financial statements; and why the charity used this method. As well the literature (*Chapter Three*) identified three complexities with fund accounting: first, whether funds were separated between restricted and unrestricted; second, the lack of guidance in GAAP as to how funds should be reported; and third, the limited guidance given in GAAP as to when funds should be consolidated due to the notions of 'control' and 'returns' not being appropriate to charities.

This research in *Chapter Six* exposed a lack of basic understanding by charities of whether their funds were restricted. With regards to recording of funds, in particular splitting them between restricted and unrestricted, being able to see what was 'freely available' aided several charities in their assessment of financial viability. It also provided transparency as to whether the charity was a going concern. However, some charities limited transparency by not including funds in their own financial statements, but recording them in separate legal entities and not consolidating them. There appeared to be three reasons for not consolidating. The first was to ensure the charity did not look 'rich' in either their assets or income. Second, the lack of available information on the separate fund(s) meant that a charity was unable to consolidate. Third, there was a lack of understanding of the accounting perspective of consolidation contrasting with the fact that they are separate legal entities, and thus not 'part' of a charity. Next, the complexities relating to the expenditure overheads ratio are considered.

9.2.4 Expenditure overheads ratio

The specific research questions relating to the expenditure overheads ratio: were they recorded separately in charities' financial statements and if so, why charities chose to separately record the ratio. The key issue identified in the literature in *Chapter Three* was the question of whether reporting the expenditure overheads ratio separately was appropriate.

There is an assumption that comparing expenditure overheads ratios provides potential donors with a recommendation on which charity to support. However, *Chapter Eight*

highlighted some difficulties in comparing expenditure overheads ratios, in particular the lack of uniformity in the presentation of financial information.

Chapter Eight also highlighted the need to balance donation-making choice between the ‘emotive’ and other aspects including the ‘financial information’ aspects of the donating decision. Part of this is achieved by ensuring that the financial information, in the form of financial statements, reflects the activities of charities. Unfortunately, this study highlighted that financial statements often lacked transparency by not telling or supporting the story of the charity, meaning that charities are left with financial statements that don’t reflect the activities of their charity.

This section examined the importance of ensuring that financial statements are not only transparent and understandable to their users but tell the full story of the charity, which currently is not achieved. Next, the overall conclusions about transparency and understandability in the financial statements of charitable organisations are reviewed.

9.3 Conclusions about the research problem

The four complexities focused on in this study were examined in the previous section; this section will highlight the insights uncovered during the interviews, some of which have not been identified in the prior literature (*Chapters Two and Three*).

9.3.1 Professional accountability

One key reason for the low level of transparency and understandability of charities’ financial statements was the poor level of professional standards of members of accounting bodies, such as NZICA. However, one insight this research found (*Chapter Six*) was that, while several interviewees utilised appropriate GAAP doing their main accounting job, for their charities work they seemed to use no standards for auditing or accounting. What was rather ironic was that for many interviewees their ‘paid’ work involved hundreds or thousands of dollars but their charity work involved at times sums in the millions of dollars.

This state of affairs cannot continue without irreparably damaging the profession of accounting. Well-meaning accountants are perpetuating this by continuing to accept unpaid or low paid work and not giving that work the time and expertise expected of a qualified accountant. This continues the expectation of charities that it is possible to pay minimally for financial statements to be prepared, and means they will face a rude

shock when their accounts are either audited or prepared by chartered accountants who follow appropriate standards and thus value their work accordingly.

This lack of professionalism must be addressed by accounting professional bodies to ensure the integrity of the accounting profession is maintained. The researcher has been involved with the national committee that seeks to act as a bridge between NZICA members and the charities sector by raising issues and educating both sides as appropriate. Further, education of preparers and users of charities' financial statements, including donors and funders, is needed as the lack of understanding of the financial management of charities is a sector problem that must be rectified to improve the public's perception of charitable organisations. Next, the insights gathered about fiduciary accountability are reviewed.

9.3.2 Fiduciary accountability

Fiduciary issues were considered under legislation and monitoring (*Chapter Seven*). This study identified three insights of particular interest to fiduciary accountability in terms of legislation. These related to: the charitable purpose definition; the registration of charities with similar names; and whether there was a need for charities to be accountable for taxation that they would otherwise have paid.

One insight from this study was the fact that New Zealand's definition of charitable purpose does not include advocacy i.e. the active support of their cause, which many within the charities sector consider an important part of a charity's role. There is a need for the Charities Commission to reconsider the limitation of charitable purpose comprising only the four heads of charity, and perhaps follow England's Charities Act 2006 by including the 'advancement of' charities' causes. Especially with many of the advocacy groups in New Zealand being refused funding due to their not being registered charities.

Another legislation problem was that charities can have similar names, which could cause confusion amongst potential donors. This needs to be considered by the New Zealand Charities Commission when they next review the registration of charities, to limit confusion by stakeholders.

The final aspect of legislation looked at the need for not only charities, but the wider NFP sector, to acknowledge the taxation benefits they gain and be accountable for justifying them. This is especially the case for charities that have chosen not to register,

such as unregistered charitable trusts, as currently, there is limited accountability regarding whether these organisations are utilising funds for their NFP or charitable purposes and consequently are deserving of the taxation benefits. There is a need for the public to feel confident that money that could otherwise contribute to the ‘public purse’, for example funding health and education, is being utilised for charitable purposes.

In relation to monitoring, once again the issue of poor professional standards arose, this time in relation to charities’ board members and charities’ auditors. Well-meaning people may be constraining charities’ ability to achieve their mission effectively by considering that they are ‘giving to the community’ by sitting on a charity Board without experience, or by accepting audit roles without an understanding of the technicalities of risk-based auditing. These people must be up-skilled to lessen the potential harm done to the image and functioning of their charity.

The altruistic nature of charitable organisations often leads to the assumption that the people within them are honest, so there is little need for any form of control. This research noted the battle taking place in some charities as some interviewees attempted to implement internal controls, to the horror of those in the charity who considered they were not being trusted. There needs to be a balance between trust and internal controls. To have trust is good but to support it with a system of internal control enhances trust. Next, the issues identified in the previous section, regarding donors using expenditure overheads ratios in their decision-making, are examined.

9.3.3 Performance accountability

As well as looking at expenditure overhead ratios this research also considered the broader question of how charities report to their stakeholders. Charities need to be proactive in convincing potential donors and funders that their charity is needful and deserving of financial support. Current performance accountability is focused on output measurements. Widening performance accountability to include three performance accountability tools, i.e. outcomes, outputs and financial viability, should lead to changes in the reporting demands from funders and also could lead to the introduction of New Zealand rating agencies to evaluate the wider range of information provided by charities for donors who may not have the skills necessary to interpret the information. Charities that refuse to evaluate their performance, could be seen as arrogant and self-absorbed by donors and thus not supported. Next, the academic contribution of this study is reviewed.

9.4 Academic Contribution

This research hopes to address the varied and wide use of the term ‘accountability’ by proposing a multi-faceted model to use when considering charitable accountability. The ‘Charitable Accountability Model’ incorporates the different aspects of accountability that charities must consider (refer *Table 9.1*).

CHARITABLE ACCOUNTABILITY MODEL	
<i>The process by which assets devoted to charitable purpose are put to their proper purpose and information about their use is made available.</i>	
1. To whom?	Stakeholders both upward (inside) and downward (outside) - refer <i>Table 9.2</i> .
2. For what?	Financial, performance and fiduciary accountability - refer <i>Table 9.3 & Figure 9.1</i> .
3. Accountability discharge documents	Examples: Financial statements, annual reports & performance reports
4. Accessibility of discharge documents	Examples: Charities’ web sites, publically accessible charities registers and rating agencies
5. Accountability discharge mechanisms	Examples: Charities boards, charities regulatory bodies and assurance engagements

Table 9-1 Charitable Accountability Model

The model recommends five facets that must be considered in relation to accountability: (1) To whom are charities accountable; (2) For what are charities accountable; (3) What accountability discharge documents charities use to discharge their accountability; (4) How accessible the discharge documents are to their stakeholders; and (5) Which accountability discharge mechanisms charities use to discharge their accountability. The first two facets will be explored further.

9.4.1 To whom are Charities accountable?

Charities are accountable to its stakeholders but who are these stakeholders? Stakeholders can be split into many different parts including (1) Upward and Downward stakeholders; and (2) Inside and Outside stakeholders. Upward stakeholders include regulatory bodies and financial supporters, including funders and donors, whereas Downward stakeholders include beneficiaries of the charity’s products or services (Connolly & Dhanani, 2009; Dhanani, 2009). Flack and Ryan (2004) consider that Inside stakeholders are those that provide resources such as donors and funders. Whereas Outside stakeholders were those stakeholders that performed a review or oversight function, for example, government regulators, the media and the general

public. Incorporating the different categories of stakeholders provides the five key stakeholder groups shown in *Table 9.2*.

<i>Stakeholders of charities</i>
(1) Resource providers including: funders; donors; lenders; and creditors
(2) Governments and their agencies including regulators and oversight bodies
(3) Trustees or Officers of charities' Boards
(4) The public
(5) Beneficiaries

Table 9-2 Charitable stakeholder groups

Next for what charities are accountable for is reviewed.

9.4.2 For what are Charities accountable?

Implicit in the concept of accountability is the question of 'what' the accountor is accountable for in order to discharge accountability. Previous research has identified eighteen different types of accountability (refer *Table 5.4*). These are grouped into similar groups leading to an accountability typology with four types of accountability the first of which – Stakeholders has already been addressed in the model (refer *Table 9.3*).

<i>ACCOUNTABILITY TYPOLOGY</i>			
<i>Stakeholders</i> (refer <i>Section 9.1.1</i>)	<i>Professional</i> <i>Accountability</i>	<i>Performance</i> <i>Accountability</i> (refer <i>Figure 9.1</i>)	<i>Fiduciary</i> <i>Accountability</i>
Downward Hierarchical Negotiated Political Public Upward	Financial Identity / Individual Personal Professional	Managerial Performance Programme Social	Fiduciary Fiscal Process

Table 9-3 Accountability Typology

As covered in *section 9.3.3* the academic contribution to this research includes proposing a broadening of performance accountability to include not only the efficiency (outputs) and effectiveness (outcomes) of charities but their continued financial viability into the future (refer *Figure 9.1*).

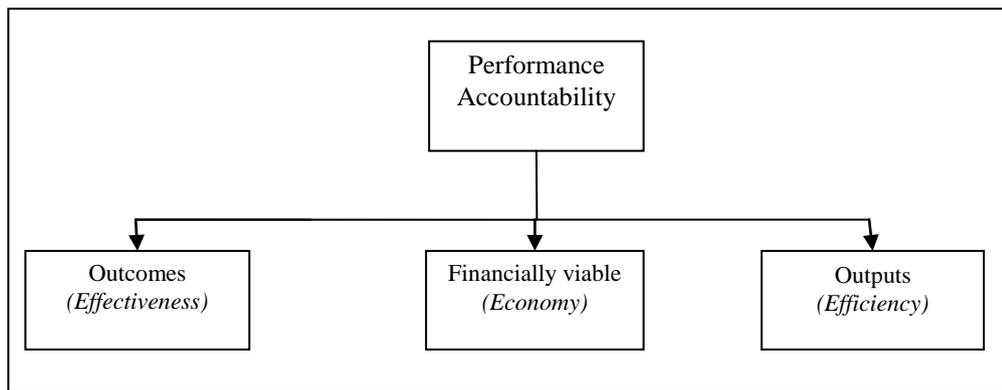


Figure 9-1 Performance Accountability

Next, implications for practice and policy in this study will be considered.

9.5 Implications for Practice and Policy

As some charities start reporting, or rather telling a clearer story, driven on by a media focus on financial statements, all charities will need to follow suit as the public will demand more than just ‘warm glow’ stories. This will drive the need for several changes in practice in relation to reporting and standards, and policy, in relation to the New Zealand Charities Commission. First, the need for charity specific financial reporting standards will be considered.

9.5.1 Charities’ financial reporting standards

Palmer and Randall (2002) considered that further study should be done on why charities were not complying with GAAP. The contribution to knowledge from this study includes the reason for charities choosing their particular accounting practice (*Chapter Six*) and the need for specific GAAP on key complexities identified in this research, in particular: the capitalisation of donated PPE; the recording of funds and reserves and the need for the ‘control’ aspect of consolidation to be explained in relation to NFPs, including charities, rather than only for-profit organisations.

It is hoped that the development of GAAP, reflected in charities’ financial reporting standards, will lead to financial statements that are understandable and transparent to all key stakeholders of charities, rather than the opaque view that currently exists. This situation will be achieved only by education and by the Charities Commission having input into the ‘Simple Format Reporting’ and prescribing the financial reporting standards. The current approach, i.e. having no prescribed format, by the Charities Commission is detrimental to the credibility of the charities sector. Next, charities’ performance reporting is considered.

9.5.2 Charities' performance reporting

In relation to performance reporting a more recent study by Connolly et al.'s (2009) has highlighted the need for charities to report and evaluate the effect that they are having on their beneficiaries (i.e. outcomes). The contribution to knowledge this study has found is that performance reporting should not be a single focus on outcomes but rather a three-prong focus on outcomes, outputs and financial viability.

The importance of performance reporting is also seen by the New Zealand Accounting Standards Review Board's current suggestion to incorporate performance reporting, in the form of a '*Statement of Service Performance*', into simple format reporting. This move is wholeheartedly supported by the findings of this research, as an essential first step. The second step is to incorporate the three-prong approach to performance reporting into any reporting format.

Whichever performance reporting format the Accounting Standards Review Board decides to propose in the amendments to the Financial Reporting Act, there is a pressing need to implement performance reporting standards, which was also supported by Connolly & Hyndman. (2003). However, for performance reporting to be successful it is essential that these performance reporting standards are 'easy to follow' and incorporate the three-prong performance reporting framework to ensure consistency between charities. Next, the need for consequences if standards are not followed is reviewed.

9.5.3 Consequences if standards not followed

Before the establishment of the Charities Register, New Zealand's Inland Revenue Department showed a distinct lack of action in ensuring organisations met their charitable purpose objective, and thus ensuring compliance with the taxation concessions received. As well the Registrar of the Incorporated Societies was not proactive in following up on Incorporated Societies that failed to submit their financial statements as required under the Incorporated Societies Act 1908.

Registered charities now suffer consequences if they are not accountable, for example in ensuring their primary objective has a charitable purpose and filing Annual Returns. Registered charities who do not meet these accountabilities will, in a worst case scenario, have their charity deregistered. As at March 2010 the Charities Commission have declined to register 1,200 organisations and removed 243 organisations from the

Charities Register, of which thirty-five were removed for failing to file an Annual Return (Charities Commission, 2010b).

However, for charities that are not registered there are limited consequences. For example, Charitable Trusts are almost free from scrutiny, as they do not have to file any accounts with their Registrar. It is hoped that these organisations will come under more intense scrutiny as to why they have chosen not to register if they exist for a charitable purpose. For as Ferguson (2005, p. 45) highlighted “*without adequate supervision the NFP [including charities] is a ticking bomb*”. Next, the need for the Charities Commission to adjust their Annual Return and broaden their registration requirements will be considered.

9.5.4 New Zealand Charities Commission

This study has identified two aspects that need consideration by the New Zealand Charities Commission. First, there is a need to consider the viability of charities by broadening the registration criteria. Second, to emphasise the importance of performance reporting there is a need to incorporate it into the Annual Return. First, the broadening of the registration criteria will be considered.

Registration would entail that the Charities Commission would consider not only the organisation’s charitable purpose but also review three requirements: (1) Charitable purpose: ensuring that the proposed charity was meeting a need by liaising with appropriate experts in the charitable purpose area, including existing charities in the area; (2) Resources: ensuring sufficient staff, both paid and unpaid, are available to cover the delivery of the charitable purpose and the administration of the charity. Also there is a need for appropriate and sufficient funding sources with expert assistance available as required, including accountants and auditors; and (3) Evaluation and review: ensuring that an effective governance structure is in place as well as appropriate levels of: professional; fiduciary; and performance accountability, with an evaluation process for all performance measurements, particularly outcome reporting.

It is important that the Charities Commission is proactive in implementing changes to the Annual Return form so that prospective donors visiting the Charities Register will be able to access information on how charities have made a difference in their beneficiaries’ lives. Waiting for the relevant changes to the Financial Reporting Act to be enacted could take some time, and change is needed now, not in the future.

This section has highlighted the key implications for practice and policy that need to be implemented to improve the transparency and understandability of charities' financial statements. A key part of this is the development of a performance reporting framework that is supported by appropriate standards. Compliance with these standards would offer charities a degree of legitimacy in the eyes of their stakeholders, especially if there are consequences for not following the standards, such as deregistration by the Charities Commission. Next, the recommendations for future research are considered.

9.6 Recommendations for future research

This research took place over a number of years, which meant that various recommendations were made for future research in particular:

- The Statement of Financial Activities applicability in New Zealand;
- The quality of the audit reports of charities, in two aspects. First, whether audit reports comply with appropriate auditing standards. Second, whether the financial statements complied with relevant GAAP and if not whether this was included in the audit report;
- What information is used by funding bodies in their decision-making, to determine whether charities' financial statements were relevant in funding bodies' decisions on whether to approve a grant.

There are also other opportunities for future research based on the implications for practice and policy, including research needed into the appropriate format for 'Simple format reporting' and the appropriate contents of financial and non-financial reporting standards.

9.7 Concluding remarks

This research has highlighted the poor state of the financial statements of New Zealand charities. The lack of transparency and understandability of charities' financial statements directly impacts on the credibility and financial viability of charities.

To enhance transparency it is important for charities to assess, and report on, their performance, to ensure that they are making a positive difference in their beneficiaries' lives. Charities have to be proactive in communicating the success of their outcomes and outputs to attract monies and to differentiate themselves from other charitable organisations. Donors and funders also need to ensure that they are supporting financially viable charities who are prudently managing their future and achieving great

success in their activities. For as Julie Helson (2010, p. 4), Executive Director of KidsCan StandTall Charitable Trust, said:

The impulse to give comes from the heart. But, as you would with any investment, use your head. To get the biggest bang for your charitable buck, be careful to donate to a good charity, not just to a good cause.

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Appendix One – Statement of Financial Activities

Table 3. Statement of Financial Activities

Reference		Unrestricted Funds	Restricted Funds	Endowment Funds	Total Funds	Prior Year Total Funds
A	Incoming resources					
A1	Incoming resources from generated funds					
A1a	Voluntary income					
A1b	Activities for generating funds					
A1c	Investment income					
A2	Incoming resources from charitable activities					
A3	Other incoming resources					
	<i>Total incoming resources</i>					
B	Resources expended					
B1	Costs of generating funds					
B1a	Costs of generating voluntary income					
B1b	Fundraising trading: cost of goods sold and other costs					
B1c	Investment management costs					
B2	Charitable activities					
B3	Governance costs					
B4	Other resources expended					
	<i>Total resources expended</i>					
	<i>Net incoming/outgoing resources before transfers</i>					
C	Transfers					
	Gross transfers between funds					
	<i>Net incoming resources before other recognised gains and losses</i>					
D	Other recognised gains/losses					
D1	Gains on revaluation of fixed assets for charity's own use					
D2	Gains/losses on investment assets					
D3	Actuarial gains/losses on defined benefit pension schemes					
	<i>Net movement in funds</i>					
E	Reconciliation of Funds					
	Total funds brought forward					
	<i>Total funds carried forward</i>					

Source: Charity Commission. (2005a, February 2005). *Accounting and reporting by Charities: Statement of Recommended Practice*. Retrieved 18 January, 2007, from <http://www.charitycommission.gov.uk/library/publications/pdfs/sorp05.pdf>

Appendix Two – Ethics approval

To: Keith Hooper
From: **Madeline Banda** Executive Secretary, AUTECH
Date: 29 February 2008
Subject: Ethics Application Number 08/18 **Understandability and transparency of the financial reports of charities.**

Dear Keith

Thank you for providing written evidence as requested. I am pleased to advise that it satisfies the points raised by a subcommittee of the Auckland University of Technology Ethics Committee (AUTECH) at their meeting on 4 February 2008 and that I have approved your ethics application. This delegated approval is made in accordance with section 5.3.2.3 of AUTECH's *Applying for Ethics Approval: Guidelines and Procedures* and is subject to endorsement at AUTECH's meeting on 10 March 2008. Your ethics application is approved for a period of three years until 1 March 2011.

I advise that as part of the ethics approval process, you are required to submit the following to AUTECH:

- A brief annual progress report using form EA2, which is available online through <http://www.aut.ac.nz/about/ethics>. When necessary this form may also be used to request an extension of the approval at least one month prior to its expiry on 1 March 2011;
- A brief report on the status of the project using form EA3, which is available online through <http://www.aut.ac.nz/about/ethics>. This report is to be submitted either when the approval expires on 1 March 2011 or on completion of the project, whichever comes sooner;

It is a condition of approval that AUTECH is notified of any adverse events or if the research does not commence. AUTECH approval needs to be sought for any alteration to the research, including any alteration of or addition to any documents that are provided to participants. You are reminded that, as applicant, you are responsible for ensuring that research undertaken under this approval occurs within the parameters outlined in the approved application. Please note that AUTECH grants ethical approval only. If you require management approval from an institution or organisation for your research, then you will need to make the arrangements necessary to obtain this. When communicating with us about this application, we ask that you use the application number and study title to enable us to provide you with prompt service. Should you have any further enquiries regarding this matter, you are welcome to contact Charles Grinter, Ethics Coordinator, by email at charles.grinter@aut.ac.nz or by telephone on 921 9999 at extension 8860.

On behalf of the AUTECH and myself, I wish you success with your research and look forward to reading about it in your reports.

Yours sincerely

Madeline Banda

Executive Secretary, Auckland University of Technology Ethics Committee

Appendix Three – Semi-structured interview Guide

INTERVIEWEE NUMBER: _____

DATE OF INTERVIEW: _____

INDICATIVE QUESTIONS

1. ACCOUNTING BASIS

- Which accounting basis was used in the preparation of the charity's financial statements?
- Why does your charity use this basis?
- How does your charity account for donations especially pledges?
- Are there any concerns with the accounting basis in your charity?

2. PROPERTY, PLANT AND EQUIPMENT (PPE)

- How does your charity record PPE in their financial statements?
- How does your charity value donated PPE?
- Why does your charity do this?
- Does your charity depreciate their PPE? If so how?
- Are there any concerns with PPE in your charity?

3. FUND ACCOUNTING

- Does your charity have any funds or reserves? Yes / No
- If Yes: What are the funds or reserves for?
- Does your charity distinguish between funds that are restricted (i.e. funds must be used for a specific purpose) or unrestricted? Why?
- Where does your charity show funds and reserves on the financial statements? Why do you show them like that?
- Are you happy with how the funds are shown on the financial statements?
- Any concerns about funds or reserves?

4. REPORTING TO STAKEHOLDERS

- Does your charity record the expenditure overheads ratio separately in the financial statements?
- If yes: Why does your charity chose to separately record the ratio?
- If not: Does your charity separately record administration and fund raising expenses so that your expenditure overheads ratio can be calculated?
- If yes: Why do you separate the expenditure?
- If no: Why do you not separate out the expenditure?
- If charities are not reporting their expenditure overheads ratio how are charities reporting to their stakeholders?

5. ANY CONCERNS ABOUT YOUR CHARITY'S FINANCIAL STATEMENTS?

Appendix Four – Consent Form

Project title: **Understandability and Transparency of the Financial Reports of Charities**

Project Supervisor: **Professor Keith Hooper**

Researcher: **Rowena Sinclair**

- I have read and understood the information provided about this research project in the Information Sheet dated 1 February 2008.
 - I have had an opportunity to ask questions and to have them answered.
 - I understand that notes will be taken during the interviews and that the interviews will also be audio-taped and transcribed.
 - I understand that I may withdraw myself or any information that I have provided for this project at any time prior to completion of data collection, without being disadvantaged in any way.
 - If I withdraw, I understand that all relevant information including tapes and transcripts, or parts thereof, will be destroyed.
 - I agree to take part in this research.
- I would like to be interviewed: At my office ; At the researcher's office
or Other: _____
- I wish to receive a summary of the findings from the research (please tick one):
Yes No

Participant's signature:

Participant's name:

Date:

Participant's contact details:

.....

.....

Approved by the Auckland University of Technology Ethics Committee on type the date on which the final approval was granted (To be completed) AUTEK Reference number 08/18

Appendix Five – Participant information sheet

Date Information Sheet Produced: 1 February 2008

Project Title Understandability and Transparency of the Financial Reports of Charities

An Invitation

You are invited to participate in a research project on the transparency of the financial reports of charities with a particular focus on the following four issues:

- Fund accounting: how funds are recorded and accounted
- Recording of property, plant and equipment
- Recording of donations: whether on a cash or accrual basis
- Expenditure overheads percentage (i.e. fund raising expenditure divided by donations received)

This project is being undertaken by Rowena Sinclair, a PhD candidate from the Faculty of Business. Participation in the project will involve a 30-60 minute interview. Your participation in this project is completely voluntary and you may withdraw from the study at any time.

What is the purpose of this research?

Rowena Sinclair is undertaking this research for her PhD thesis at Auckland University of Technology and she hopes to publish the findings at conferences and in academic and professional journals.

How was I chosen for this invitation?

You have been invited to participate in this research as you are involved in either preparing or auditing the financial accounts of a charity whose income is greater than \$100,000. Your name came from another participant or through organisations such as: New Zealand Institute of Chartered Accountants, New Zealand Charities Commission or the Community and Voluntary Sector Research forum.

What will happen in this research?

You will be asked to sign a participation consent form and take part in an interview at a time and place that is convenient to you. The interview questions will focus on your experiences of charity financial reporting in relation to the four issues identified above. The interview will be recorded via audiotape and note-taking. This will be analysed by common themes.

What are the discomforts and risks?

One possible risk is that you will be asked to provide some sensitive accounting information on the charity/charities you are involved in.

How will these discomforts and risks be alleviated?

This risk is alleviated by the fact that the only data being collected is technical accounting processes. All information you provide is confidential and neither the name of the charity nor your name will be identifiable in any reports or publications resulting from this study. Also you have the opportunity to use an interview venue rather than at the organisation that you are providing information for.

What are the benefits?

It is expected that participation in this project will help accounting researchers and practitioners (such as yourself) to understand any issues that need to be addressed in securing the appropriate transparency of charities' financial reports, particularly with regard to the need to provide financial information in the Charities Register.

How will my privacy be protected?

No identifying data will be used in the write-up of the results and your privacy will be fully protected. The final published proceedings will identify participants only by a two-letter code.

What are the costs of participating in this research?

There are no monetary costs involved in the participation of this research and it is expected that participation in the interview will require no more than 60 minutes of your time.

What opportunity do I have to consider this invitation?

You are requested to consider and respond to this invitation within the next two weeks.

How do I agree to participate in this research?

If you agree to participate please return the attached consent form. Please also advise me of the times that you are available for an interview and the place that you would prefer the interview to take place.

Will I receive feedback on the results of this research?

It is anticipated that a summary of the findings will be available within 12 months of completion of the project and copies of this will be made available if requested.

What do I do if I have concerns about this research?

Any concerns regarding the nature of this project should be notified in the first instance to the Project Co-Supervisor, Professor Deryl Northcott, deryl.northcott@aut.ac.nz, phone (09) 921 9999 ext. 5850.

Concerns regarding the conduct of the research should be notified to the Executive Secretary, AUTEK, Madeline Banda, madeline.banda@aut.ac.nz, (09) 921 9999 ext. 8044.

Whom do I contact for further information about this research?**Researcher Contact Details:**

The researcher's contact details are: Rowena Sinclair, Rowena.sinclair@aut.ac.nz, (09) 921 9999 ext. 5377.

Project Supervisor Contact Details:

The co-supervisor's contact details for this project are: Professor Deryl Northcott, deryl.northcott@aut.ac.nz, phone (09) 921 9999 ext. 5850.

Approved by the Auckland University of Technology Ethics Committee on *type the date final ethics approval was granted*, AUTEK Reference number 08/18.

Appendix Six – Transcriber’s Confidentiality Agreement

Project title: **Understandability and Transparency of the Financial Reports of Charities**

Project Supervisor: **Professor Keith Hooper**

Researcher: **Rowena Sinclair**

- I understand that all the material I will be asked to transcribe is confidential.
- I understand that the contents of the tapes or recordings can only be discussed with the researchers.
- I will not keep any copies of the transcripts nor allow third parties access to them.

Transcriber’s signature:*Nicole Haisman*.....

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Appendix Seven – NVivo Tree nodes

Key: *Sources (References)*

Heading 1	Heading 2	Heading 3
Accountable 11(20)		
Accounting basis 6(10)	Accrual 7(14)	Certainty (Pledges) 2(3) Uncertainty 2(3)
	Cash 3(6)	
	Modified accrual basis 1(1)	
Assurance 2(3)	Audit 23(91)	
	Review 2(3)	
Budgets 10(27)		
Charities Commission 4(6)	Annual Return 11(25)	
	Monitoring 4(11)	
	Registration 12(28)	
Financial statements 10(39)	Functional 2(7)	
	IFRS 5(11)	
	MED & ASRB proposal 2(3)	
	Old GAAP 1(1)	
Fund accounting 0(0)	Recording and Disclosure 21(78)	
	Separate entities 11(46)	Consolidation 9(20) Not consolidated 12(35)
	Types and Purpose 20(57)	
Funders 23(102)		
Funding 19(60)	Advertising 2(3)	
	Charitable Trust 7(21)	
	Professional fund raisers 4(8)	
Governance 17(62)	Agency 2(7)	
	Stakeholder 3(10)	
	Stewardship 9(25)	
Interviews 1(1)		
Professional services 2(13)		

Heading 1	Heading 2	Heading 3
Property, plant & equipment 5(10)	Depreciation 4(11)	
	Valuation 18(42)	Bought 1(1) Donated 15(38)
Reporting to Stakeholders 20(72)	Outcome 39(116)	
	Output 17(41)	Administration 9(19) Fundraising i.e. Exp O/H 16(42)
	Words only 3(6)	
Resistance to controls 10(28)		
Sustainability (financial) 8(30)		
Taxation 10(14)	GST 1(1)	
Terrorists 3(7)		
Transparent 24(50)		
Understandable 29(80)	<i>Includes 'in kind' items</i>	
Validity 15(24)	<i>Includes reason for giving</i>	
Visible financial statements 14(31)		
Volunteers 8(12)		