

Has Sector Neutrality had its day?

Rowena Sinclair & Carolyn Cordery, Not-for-profit Sector Advisory Committee

The Ministry of Economic Development (MED) and the Accounting Standards Review Board (ASRB) have produced two discussion documents that propose radical changes to the statutory framework for Financial Reporting and Assurance in New Zealand (see also other articles in this Journal). Submissions to these reports need to be in by 29 January 2010 and all members are encouraged to make submissions.

Key issues for Not-for-profit organisations

Of particular relevance for not-for-profit organisations (NFPs) is: the definition of public accountability; the proposed standard setting regime; the proposed reporting and assurance framework; and the ASRB's proposed abandonment of sector neutrality. The MED's and ASRB's position on these are outlined below.

MED 2009 Discussion Document

The 2009 MED discussion document carries through several suggestions in the 2004 reports (see "progeny" insert). In particular it nominates the Financial Reporting Act 1993 as a vehicle to determine who should report. It again proposes setting up the ASRB as a single independent crown entity responsible for preparing and approving not only financial reporting standards but also assurance standards.

The MED document considers that the primary principle for financial reporting is to provide information to external users who have a need for an entity's financial statements but are unable to demand them. MED considers that entities which meet any one of the three indicators through public accountability; economic significance and separation between ownership and management must prepare General Purpose Financial Statements (GPFR) in line with the ASRB requirements. The Appendix in the MED document summarises the impact on each type of entity.

- **What is public accountability?**

The MED considers that public accountability arises when an entity raises money directly from the public. For NFPs this would include: registered charities and other NFPs who raise money from the public e.g. charitable trusts who have chosen not to register.

As may be inferred from para 116, NFPs may also be publicly accountable if they are relieved of other public taxes, such as Territorial Local Authority rates. This potentially broadens public accountability to all not-for-profit organisations that forego tax, for example, sports and recreation bodies. If an organisation meets the public accountability criteria, they will have to publish their financial and non-financial reports and obtain assurance on these annually (unless they are very small, see below).

- **What is economic significance?**

The MED considers that entities are economically significant and are therefore required to publish GPFR that are independently assured if they impact their economic or social economy regionally or nationally. This consideration extends to employees, creditors, customers, and, for NFPs, volunteers and beneficiaries. They recommend \$20million of operating expenditure as a threshold for economic significance.

- **What is separation of ownership and management?**

The MED considers that most NFPs will have separation between their members, volunteers and other resource providers and their management. Managing bodies (Boards, Trustees) are often representative but typically separate from the members themselves. While this implies a requirement for all organisations to report, due to cost-benefit considerations, small NFPs will have to prepare GPFR only if they are publicly accountable, or their members ask them to do so.

- **Audits and reviews**

Currently there are no statutory requirements for

Progeny of the Discussion Documents

The MED initially commenced a review of the Financial Reporting Act 1993 in 2004. The 1st discussion document (<http://www.med.govt.nz/upload/8296/FRAdiscussion.pdf>) released in March 2004 considered the financial reporting structure in New Zealand including the requirements for audit. Key considerations were the extension of an IFRS-based set of financial reporting standards with universal application to all types of entity i.e. entity neutrality, applying financial reporting standards outside the profit-seeking corporate sphere to governmental agencies and other "public benefit" entities.

A second discussion document (<http://www.med.govt.nz/upload/8372/2discussion.pdf>), released in November 2004, responded to submissions. In particular, the discussion document proposed reconstituting the existing Accounting Standards Review Board to a more "active" role of being formally responsible for all parts of the standards setting process. This discussion document also proposed that the Financial Reporting Act would determine the content of financial reporting standards i.e. setting generally accepted accounting practice (GAAP). In addition it included a discussion on technical neutrality to facilitate developments such as XBRL ("eXtensible Business Reporting Language") and whether it is appropriate for audit standards to be subject to the same independent oversight as accounting standards. It also sought preliminary views on the regulation of auditors.

The 2009 ASRB discussion document carries several suggestions from the MED's 2004 documents namely the concept of tier-reporting in relation to who needs to report and what assurance level they require.

NFP accounts to be audited, although many organisations are required to by their constitutions. The MED discussion document recognises that the cost of mandatory audits can be high in relation to NFP organisations' incomes. Therefore it has invited the ASRB to define levels at which a (lower cost) review engagement is a minimum requirement, although it notes that entities may choose the higher assurance offered by a full audit.

- **Standard setting regime**

The MED document proposes that financial reporting and assurance standards are developed and approved by a reconstituted ASRB (called an External Reporting Board). However, the ASRB document acknowledges the different skills required for such a Board and suggests two standard setting boards within this body which would cover promulgation of accounting and assurance standards respectively. The ASRB has taken this opportunity to point to its preferred direction of financial (and non-financial) reporting.

ASRB 2009 Discussion Document

The ASRB has developed a discussion document which dovetails in with the MED proposal regarding which entities should have financial reporting obligations. The ASRB sought to create an enduring framework that will cope with changes in the foreseeable future and to meet the needs of users, whilst bearing in mind issues such as simplicity and the trans-Tasman position. (The Trans-Tasman Accounting Standards Advisory Group has already proposed establishing a single set of trans-Tasman accounting standards.)

- **Sector neutrality**

Perhaps one of the more controversial proposals for the NFP sector is the proposed abandonment of "Sector neutrality". The ASRB acknowledges that there is a growing consensus that NZ IFRS is not well suited to deal with the information needs of non-capital market users. Their tentative proposal is to have reporting standards in each of three sectors: (1) for-profit; (2) public benefit; and (3) not-for-profit. Within the NFP framework, the ASRB document proposes three tiers of reporting for private not-for-profit entities. These tiers cover both reporting requirements and the appropriate assurance engagement required, if any. They are set with the notion of cost-benefit in mind.

- **Reporting tiers**

The ASRB has suggested reporting tiers of (from p.43 of their document):

Tier 1 Large: all organisations with expenditure \geq \$10m

Tier 2 Medium: publicly accountable organisations or issuers with expenditure $>$ \$1m and \leq \$10m¹

Tier 3 Small: publicly accountable organisations with expenditure \geq 20k and \leq \$1m.²

There has been much discussion over recent years as to what makes an appropriate indicator of size in the NFP sector. As a majority of NFPs do not have staff, the number of equivalent full-time staff is seldom the useful indicator that it may be in other sectors. The combination of assets and revenue is also difficult as, in any one year, bequests or other significant fund-raising can 'bump' an NFP into a new category. The NFPSAC does not believe that the indicator of expenditure is perfect, but it is simple and is also the indicator being suggested in Australia and therefore it does have some merit.

For large NFPs, an application of Public Benefit Entity Standards (PBEs) with a full audit has been suggested. These standards may well be adapted International Public Sector Accounting Standards, developed for private NFPs over the next 2-3 years. Differential reporting exemptions will be applied to these PBE Accounting standards for medium entities, while a standard accrual format is being suggested for small NFPs. Small NFPs could opt for a review engagement rather than a full audit and no review is required if their expenditure is less than \$100,000. For entities that have expenditure of less than \$20,000 annually, there will be no GPFR requirement. However, it may be useful for these organisations to use the standard format for consistency and to communicate with their stakeholders.

In addition to the framework for financial reporting, the ASRB's discussion document also recommends that NFPs produce non-financial reporting. While this has been recommended in the past, there has never been a statutory requirement. The NFPSAC believes that good quality non-financial reporting can show users the difference that a NFP has made to beneficiaries and as such this type of reporting is essential.

What can you do?

These are some of the most far-reaching proposals since the Charities Bill and impact a wider set of entities. The proposed imposition of a reporting framework in the NFP sector is both long-awaited and necessary. With the format of a particular GAAP yet to be developed, there is obviously much discussion

¹ Entities that are not publicly accountable but have expenditure at this level and membership of 10 or more, will also be required to report at Tier 2 levels.

² Entities that are not publicly accountable but have expenditure at this level and membership of 10 or more, will also be required to report at Tier 3 levels.

and input still required. However, the proposed abandonment of sector neutrality has important consequences for the profession and it is vital that you exercise your democratic right to participate by submitting a proposal on behalf of either an NFP organisation that you work for or give advice to. The NFPSAC will be supporting a number of information sessions in different centres (check for these on our website: www.nzica.com/nfp) and will also publish on our website its submissions to both of these documents. The NFP Special Interest Groups in Auckland, Wellington and Christchurch will also be assisting with this.