31 March 2021

April Mckenzie
Chief Executive
External Reporting Board
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Via website: www.xrb.govt.nz

Dear April

Submission on Simple Format Reporting Standards – Post-implementation Review

As the representatives of over 280,000 professional accountants in Australia, New Zealand and around the world, Chartered Accountants Australia and New Zealand (CA ANZ) and CPA Australia welcome the opportunity to make a submission to the External Reporting Board (XRB) on its Post-implementation Review (PIR) of the Simple Format Reporting Standards applied by Tier 3 and Tier 4 public benefit entities (PBEs).

CA ANZ and CPA Australia welcome the PIR as it is an important exercise in establishing whether the Tier 3/4 standards remain fit for purpose and what, if any, improvements are required to ensure their ongoing applicability.

Feedback from our members and other stakeholders indicates that whilst the framework that includes the Tier 3/4 standards has been a worthwhile exercise and has been implemented well overall, there are significant areas for improvement, in particular within the Tier 4 Reporting Standard. We also observe that the findings from the PIR and subsequent developments could benefit future financial reporting by the Australian Not-for-profit (NFP) sector as they could inform the Australian Accounting Standards Board (AASB) and its current project to develop a differential reporting framework for the Australian NFP sector.

The Tier 3/4 standards are widely used in New Zealand across the NFP sector, including a significant number of Māori NFP organisations that are registered charities and other public sector entities. The *Charities Act 2005* requires all registered charities to prepare and lodge financial statements based on XRB Reporting Standards. According to the 2019/2020 Annual Review[1] published by Charities Services, a large proportion (93%) of the 27,700 registered charities in New Zealand currently apply either the Tier 3 (36%) or Tier 4 (57%) standards in complying with their financial reporting obligations.

The aforementioned Charities Services Annual Review notes that smaller charities experienced the greatest difficulties in complying with financial reporting requirements, particularly in the last two years. Only 72% of smaller charities applying the Tier 4 standard were considered compliant in 2018 with compliance declining to 59% in 2020. This compares to a 94%-100% compliance by other charities in Tier 1/2/3 over the same period. It is possible that the COVID-19 pandemic was a contributing factor in the decline in compliance in 2020. However, these

[1] Charities Services Annual Review Report 2020

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findings suggest that any significant improvements may need to be focused on the Tier 4 standard. Feedback we have received from our members also appears to validate these findings, suggesting that any improvements should be focused on the Tier 4 standard applicable to smaller charities.

As noted in the Request for Information, the PIR and any improvements to the Tier 3/4 standards arising thereon could also have a bearing on the Incorporated Societies Act Reform[2] that is currently in progress. There are over 23,000 organisations that operate as incorporated societies, of which about two thirds are not registered charities and therefore do not currently have statutory financial reporting obligations. A draft bill to replace the *Incorporated Societies Act 1908*, which is pending approval by Cabinet for introduction to Parliament, proposes to require all incorporated societies to report in accordance with standards issued by the XRB when they satisfy one or more of the following criteria:

- annual payments of $10,000 or more; and/or
- assets of $30,000 or more; and/or
- donee status under the Income Tax Act 2007.

In our view, the current four-tiered differential reporting framework for PBEs adequately addresses the differing reporting needs of PBEs based on their size. While this structure provides an appropriate platform for proportional statutory reporting requirements, feedback received from our members suggests that the current single mechanism of operating expenditure/payments to decide the tier of reporting by a PBE may not always be the most appropriate way to determine the relevant reporting Tier. This is particularly relevant for PBEs with low operating expenditure/payments that hold assets of significant value. The incorporated societies reform proposals referred to above accommodate this multiple criteria based approach and we suggest the XRB also takes this into consideration in developing improvements to the PBE four-tiered reporting framework.

The **Attachment** to this letter sets out our responses to the specific questions posed in the Request for Information. If you have any questions about our submission, please contact either Amir Ghandar (CA ANZ) amir.ghandar@charteredaccountantsanz.com or Ram Subramanian (CPA Australia) at ram.subramanian@cpaaustralia.com.au.

Your sincerely

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[2] https://www.mbie.govt.nz/business-and-employment/business/regulating-entities/incorporated-societies-act-review/

Attachment

Specific matters for comment

1. What is your overall view on how the standards are working? To help you answer this question you might want to consider whether:

(a) performance reports prepared using the standards provide the right kind of information;

(b) any new issues have emerged since the standards were issued;

(c) there is anything we did not think about or anything we did not get right; and

(d) the costs of applying the standards are higher than you expected.

The four-tier structure is one of the world-leading approaches to differential financial reporting for PBEs that appropriately balances risk and reporting complexity. However, as identified in our cover letter, the level of non-compliance by smaller charities required to apply the Tier 4 standard indicates that the XRB's efforts should be focused on improving the requirements for this Tier. This is particularly relevant since New Zealand has a significant number of very small charities and many are staffed by volunteers with minimal financial expertise. Many of our members have expressed the view that whilst qualified accounting professionals will have little difficulty in applying the Tier 4 requirements, the same cannot be said for volunteers and staff with little accounting knowledge who are often tasked with the preparation of financial reports for smaller charities.

The Tier 4 standard consists of over 30 pages, with an additional 46 pages of guidance. We consider the length and complexity of the Tier 4 standard could be substantially reduced and simplified to enable smaller charities to apply the requirements while preserving the transparency and accountability required for these entities. Simplifications could be made to both the length of the standard and to some of the terminology used, that may not be very well understood by those with no, or limited, accounting background. Some suggestions for simplification include:

- Reducing the number of line items included in the Statement of Receipts and Payments. We note for both receipts and payments, there are several subheadings which may not be commonly used by Tier 4 entities due to their size and simple nature of operations. In particular, we believe any information presented after the Operating Surplus or (Deficit) line item should be optional. Including elements of both an income statement and a cash flow statement may be complex to understand and apply by those with no, or little, accounting background. We suggest including only end-of-year balances for bank and cash balances in the balance sheet.

- Renaming the Statement of Resources and Commitments to "balance sheet" or "assets and liabilities" and reducing the number of line items included in this statement. We suggest simplifying this statement to include a minimal list of assets and liabilities that the entity can easily determine (e.g. bank balances and cash at the end of the year). The level of detail required currently undermines the "cash based" approach to the Tier 4 standard.

- Simplifying some of the terms used. We note there are several terms included in the Tier 4 standard which may be commonly used within the accounting profession but may not be very well understood by others with little or no accounting background and are involved in the preparation of financial statements on a cash basis. Such terms include:
    - No offsetting of amounts
    - Schedule of resources
    - Schedule of commitments
    - Description and Source of Value (cost or current value required if practicable to obtain)
    - Guarantees
    - Grants or Donations with Conditions Attached (where conditions not fully met at balance date)
    - Resources Used as Security for Borrowings
    - PBE SFR-A (NFP)
- Reconsidering the need to assess whether a Tier 4 entity is "publicly accountable". In our view the risk of Tier 4 entities meeting the definition of public accountability is relatively low and removing this requirement reduces complexity.
- The current standard templates should be substantially simplified. As an example, the optional Excel template is lengthy, with fourteen individual sheets including four separate sheets for notes to the performance report. A simple template with drop down boxes and prepopulated headings potentially would be much more effective.

The current Tiers 3 and 4 standards comprise both "required" information and "optional" information within the main standards. The optional information, which some entities may consider beneficial to provide, increases volume and complexity of the standards, especially for smaller Tier 4 preparers who only have to comply with the required information. Our outreach to members recommends removing the optional information from the standard and including it either as an appendix to the standard or as separate guidance for entities who may wish to use it.

As noted in our cover letter, currently there is a single mechanism (operating expenditure for Tier 3 PBEs and operating payments for Tier 4 PBEs) used to decide the Tier to which a PBE belongs. There are likely to be many very small entities, in terms of their operating expenditure/payments using this criterion but which have a large asset base. In our view, operating expenditure/payments alone may not be the only method to measure a charity's size and may be misleading in some circumstances. The draft incorporated societies bill is proposing to introduce tiered reporting based on three criteria: income, assets and donee status. We recommend consideration be given to introducing a dual-criteria measure (income and assets) to improve the reporting outcomes for the NFP sector. If such an approach is pursued, we suggest retaining the current two-year test for entities moving between tiers.

We note that charities in Tiers 1, 2 and 3 are required to report annually on the funds they have accumulated over their lives and are also required to state their reserves and describe the restrictions and/or purposes of their reserves. Our view is that there is scope to improve the narrative description of a charity's accumulation strategy, purposes and restrictions, on the grounds of increased transparency and enhanced confidence in the sector. We consider this requirement to disclose a reserves policy may be better placed within the accounting standards rather than legislation.

2. What parts of standards, guidance or templates have been working well? Are there any that have been particularly useful?

We have received several positive comments about the Tier 3 standard during our member outreach, as highlighted below:

- The Tier 3 standard, guidance and templates are generally working well, subject to our comments below in respect of the statement of service performance and the provision of guidance on frequent transactions.
- Many Tier 3/4 entities make use of the templates to prepare their performance reports, although as noted above in our response to Q1, we have suggested some potential ways to simplify the Tier 4 template.
- Entities find the option to elect to apply the requirements of a PBE Standard that is part of the Tier 2 PBE Accounting Requirements, for non-routine or one-off transactions, helpful.
- The guidance issued by the XRB, such as the FAQ publication on *Changing Your Reporting Tier* and NFP Tier 3 FAQs on *Assessing and reporting on your entity's ability to continue operating*, aimed at helping Tier 3 and Tier 4 not-for-profit entities understand the requirements for changing their reporting tier, is considered to be useful.

3. Are there any specific issues that you have encountered in applying the standards, guidance, or templates? If you can, please outline:

(a) the specific part of the standard, guidance, or templates that you are commenting on (where relevant);

(b) the types of entities affected, how many entities are affected (if you know) and the impact the issue has on them; and

(c) how the issue should be addressed.

Please refer to our comments in the cover letter and in response to Question 1 above.

Generally, smaller charities and other NFP entities with limited resources find it challenging to prepare the Statement of Service Performance and effectively report on relevant outcomes and outputs that are measurable in the manner expected by the Tier 3/4 standards. Often, smaller entities do not have the systems or resources to record service performance information. We suggest the development of illustrative examples, and practical approaches to describe and report "outputs" and "outcomes" and other reporting mechanisms, to help improve the reporting of service performance.

The Tier 3 standard permits entities to elect to apply the requirements of the Tier 2 PBE standard to specific transactions (e.g. investment properties, heritage assets and financial instruments, such as equity investments). When an entity elects to apply the Tier 2 standard, it is required to apply that option to all transactions of that type and cannot choose to return to applying the Tier 3 standard for such transactions unless there is a change in the accounting policy. Feedback we have received from our members indicates a need to introduce simple requirements within the Tier 3 standards for such types of transactions that are more common across the NFP sector, such as fair valuing investment properties and equity investments. Currently, such entities have to rely on the Tier 2 standard when accounting for these transactions. Complying with the full requirements of a Tier 2 standard in this manner, for more frequent transactions, can be complex and time consuming.

4. Have you developed any custom guidance to help apply the standards? If yes, please tell us what the guidance covers and whether you think it could be useful to others? We would love to see a copy of it (by separate email to submissions@xrb.govt.nz). Any guidance you send us will remain confidential and will not form part of your formal comments.

CA ANZ and CPA Australia have issued several publications to enhance financial reporting outcomes by NFPs and Charities. These guides are designed to assist preparers and auditors to effectively interact with the NFP accounting standards framework in New Zealand.

CA ANZ guidance:

- Guidance for not-for-profit financial reporting in New Zealand
- Enhancing not-for-profit reporting
- Guidance for assurance engagements for NZ not-for-profits

Guidance issued by CPA Australia:

- A guide to understanding the financial reports of not-for-profit entities (New Zealand)

5. Do you have any other comments you would like to raise about the standards, guidance, or templates?

As stated in the cover letter, there are a significant number of Māori NFP organisations in New Zealand that use the Tiers 3 and 4 standards by virtue of being registered charities or part of a larger audited group. The current standards do not include guidance notes in Te Ao Māori and do not include examples specific to Māori organisations. We note reference to "Koha" twice in the guidance notes as part of donations and revenue from members, but there is no proper definition or description provided of Koha in the context of donations. As an example, there are different types of Koha which are generally given or received for various services including food, building services, gifts to welcome members in Marae and more.

The guidance on related parties also is difficult to apply in the case of a Marae where many stakeholders/members may be related by being close members of families. Another pertinent matter in Maori organisations is the accounting treatment of Maori land, including lands provided through inheritance and cemeteries. Our members have informed us there is a lack of guidance on this matter and that information needed to estimate fair value is not readily available.

Based on feedback received from our members, we recommend that the NZASB consider performing detailed outreach on these matters to gather evidence of matters relevant to Maori organisations. In the meantime, consideration should be given to providing specific guidance and examples reflective of the issues raised in this submission, including a financial report template translated into Te Ao Māori where relevant.

Accurate compliance with financial reporting requirements by charities at all tiers is critical to public trust and the integrity of the system. Non-compliance with reporting standards, especially at the Tier 4 level, is an issue arising from a lack of financial literacy and understanding of accounting concepts. It is important for the board members and trustees of smaller charities to possess the appropriate skillset, financial literacy and access to adequate resources to ensure these entities can better fulfil their statutory obligations. We recognise that Charities Services and the XRB commit significant time and resources to assist smaller charities to meet their financial reporting compliance requirements. We recommend that the NZASB conduct further outreach to assess whether the current support and guidance is sufficient and, if not, consider providing training events on the current requirements, guidance, and templates.