

**Light-handed charity regulation: its effect on
reporting practice in New Zealand**

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Light-handed charity regulation: its effect on reporting practice in New Zealand

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Internationally, there has been a steady increase in the number of countries instigating charity regulation. While the Charity Commission for England and Wales was established by the Charitable Trusts Acts of 1853, since 2005 the Office of the Scottish Charity Regulator, Charity Commission for Northern Ireland and the Singaporean Charity Council were established almost contemporaneously with New Zealand's Charities Commission. In other countries (such as Canada and the United States) tax authorities register and monitor charitable activity leading to a perception that charities need regulation if the donating public's trust and confidence is to increase.

Public interest theory suggests that regulation increases organisational transparency through reducing information asymmetry, protects (or encourages) a competitive market, leading to a distribution of resources which is in the public interest (Gaffikin, 2005). While these arguments are commonly used to call for regulation in the private (for profit) sphere, nonetheless they may explain the increase in the number of bodies regulating charities internationally.

Notwithstanding a need for regulation, the cost of complying with these regimes is often an issue, especially for small and medium-sized charities and therefore regulator tend to take a light-handed approach to small and medium charities' information provision (for example, Hind, 2011; Morgan, 2010a). Responding to the call by Hyndman and McDonnell (2009) for research into charities regulation, its rationale and operation, this paper ascertains the impact of a light-handed enforcement regime on small and medium charities' reporting. In so doing, it analyses the General Purpose Financial Reporting (GPFR) practices of a selection of 300 small and medium-sized charities registered with the New Zealand Charities Commission against the Charities Act requirements and hence the rationale for this regulator. It uses this analysis to predict how the regulator's activities might impact future reporting practices of charities.

Key Words: Charity regulation, charity reporting, charity compliance.

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1. Introduction

Internationally, there has been a steady increase in the number of countries instigating charity regulation. As examples of independent regulators, the Charity Commission for England and Wales was established by the Charitable Trusts Acts of 1853 and regulates over 160,000 charities, while since 2005 the much smaller Office of the Scottish Charity Regulator, Charity Commission for Northern Ireland and the Singaporean Charity Council were established almost contemporaneously with New Zealand's Charities Commission. In other countries (such as Canada and the United States) tax authorities register and monitor charitable activity. Charity watchdogs [such as GuideStar and Better Business Bureau's (BBB'S) Wise Giving Alliance] have also established in recent years. As Szper and Prakash (2011, p.116) note "there is a perception, correct or incorrect, that nonprofits have transparency issues" and therefore that regulation is required to improve charities' transparency and accountability.

Public interest theory suggests that regulation increases transparency through reducing information asymmetry, protects (or encourages) a competitive market and leads to a distribution of resources which is in the public interest. While these arguments are commonly used to call for regulation in the private (for profit) sphere, nonetheless they may explain the increase in the number of bodies regulating charities.

Such regulators typically require charities to disclose financial and other information in the belief that information asymmetry gives rise to the potential for opportunism in charities and other not-for-profit organisations due to the lack of 'owners' (Desai & Yetman, 2005). Indeed, Desai and Yetman (2005) found that US regulatory requirements for charities to return financial information leads to lower compensation of officers and directors and thus, maximises funds available for charitable distribution. Regulating increased charity information may therefore build the donating public's trust and confidence (Hyndman & McDonnell, 2009).

Notwithstanding a need for regulation, the cost of complying with these regimes is often an issue, especially when small and medium-sized charities must increase their reporting. While regulators require large charities to comply with minimum reporting standards, they tend to take a light-handed approach to small and medium charities' information provision (for example, Hind, 2011; Morgan, 2010a).

Responding to the call by Hyndman and McDonnell (2009) for research into charities regulation, its rationale and operation, the objective of this paper is to ascertain the impact of a light-handed enforcement regime on small and medium charities' reporting. In so doing, it analyses the General Purpose Financial Reporting (GPFR) practices of a selection of charities registered with the New Zealand Charities Commission against the Charities Act requirements and hence the rationale for this regulator. It uses this analysis to predict how the regulator's activities might impact future reporting practices of charities.

The paper proceeds as follows: first the rationale for charities' regulation and reporting is provided and tested against the oldest charity regulator (the Charity Commission of England and Wales). In

section three the New Zealand context is described and the research design presented. Following the research results, the paper continues with a discussion and conclusion, including limitations and opportunities for further research.

2. Regulation in the charities sector

2.1 The impetus to regulate

A number of theories of regulation and the fact that the need and imposition of regulation is both contextually and temporally specific, make discussions of regulation complex (Gaffikin, 2005). A prominent regulation theory rises from concerns that private interest will outweigh the public interest in business operations and that, due to information asymmetry, regulation is needed to protect the public interest. Public interest theory suggests a regulator will facilitate activities in the private sphere to: (i) address information asymmetries in a manner equitable both to the regulated (preparer of the information) and to the users of the information, and (ii) to maintain an environment which encourages competition and fair distribution of resources (Gaffikin, 2005). Within such a regime, regulators are expected to set minimum standards, increase the amount of publicly available information and enhance comparability across entities (Brown, 1990).

These arguments may also be adapted to explain regulation in the private charity sphere. High information asymmetry exists due to the prevalence of unreciprocated (non-exchange) contributions to charities (Falk, 1992) and due to the lack of ownership (Desai & Yetman, 2005). Accordingly, for example, the UK Charities Act 2006 requires the Charity Commission in England and Wales to (amongst others) 'inspire public trust and confidence in charities' and to 'enhance the accountability of charities to donors, beneficiaries and the general public'. The Charity Commission enhances accountability by careful attention to information asymmetries of these users (donors, beneficiaries and the general public) and reports that public trust and confidence in charities continues to increase (Hind, 2011).

Notwithstanding regulators' intentions to enhance accountability, incidences of fraud continue to occur as shown by Fremont and Kosaras (Fremont-Smith & Kosaras, 2003). Further, poor reporting by charities leads to a lack of transparency (as shown in section 2.3).

Regulation can also be developed to maintain competition in certain markets (Gaffikin, 2005). Competition is encouraged due to the belief that it will result in effective and efficient use of scarce resources both of those who pay for a market-provided service or good, and within the organisation that provides it. Further, regulation within a competitive market can lead to more just distribution of resources (Gaffikin, 2005). Potentially this rhetoric of the efficient market may be observed in charity regulation. For example, the UK Charities Act 2006 requires the Charity Commission in England and Wales to (amongst others) 'promote the effective use of charitable resources'. The manner in which the Charity Commission makes information available about large charities on its website, and the UK government's sponsorship of an information website (GuideStar) (see Dhanani, 2009) provide evidence of the regulator's desire to encourage competition in the charities market which may also lead to the more fair distribution of resources throughout the sector. This is all the more important, suggest Hyndman and McMahon (2011), due to the increasing amounts of government funding into the charities sector (especially for the provision of social services). Hind (2011) also notes that a role

of the Charity Commission of England and Wales has been to promote public interest in charity, and this also speaks of the creation of a market.

Not all agree that public interest theory can explain regulation, as the term 'public interest' is ill-defined and these theories do not sufficiently consider the competence and independence of the regulator (Gaffikin, 2005). This is not such an issue in the charity case, as the public interest has been defined by statute ('promoting public trust and confidence in charities'), although it is recognised that robustly measuring trust and confidence can be difficult.

Further, the vision of the Charity Commission in England and Wales notes it is to be 'the independent regulator for charitable activity...' Its independence ensures that interest groups (including government, charities themselves and, to a lesser extent the public) cannot capture the regulator. Independence also means that the regulator will sanction charities' short-comings by de-registration and, in extreme cases, convictions through the court process. Thus, the regulator's process needs to be open, transparent, accountable and acceptable.

Self-regulatory regimes are frequently criticised due to a lack of independence (perceived or otherwise) (Gaffikin, 2005) and accordingly self regulation in the charities sector has occurred only infrequently and has experienced only limited success (Cordery & Baskerville, 2007). It may also not be popular with a diverse sector. Cordery and Baskerville (2007) note that when the New Zealand government consulted on the need or otherwise for a Charities Commission (in its 'Tax and Charities' review of 2001) a majority of the 1682 submissions supported or accepted the need for an external regulator of the charitable sector, rather than arguing for self-regulation instead.

Charities' regulators tend to use compliance approaches to encourage and educate charities rather than enforcing requirements through deterrence approaches. A compliance approach is flexible and less confrontational (Gaffikin, 2005), as can be observed with the Charity Commission in England and Wales which viewed its role in the early 21st century, as "being akin to regulating angels" (Hind, 2011, p.202). The benefits of a compliance approach are that regulation can be carried out more efficiently and therefore with less cost. Yet, compliance approaches are more susceptible to being captured by interest groups and may lead to a lack of sufficient regulatory resources (Gaffikin, 2005). Compliance monitoring is evident from the manner in which charities regulators assume an education role.

Regulation requires charities to disclose financial and also non-financial information as to the difference they make within communities to meet users' needs for accountability and for decision-making about future donations and relationships with charities. Both charity reporting users and their needs are potentially many and varied. In the United Kingdom (UK), Bird and Morgan-Jones (1981) asserted that there are six user types. The New Zealand Institute of Chartered Accountants' (2007) Not-for-Profit Financial Reporting Guide lists 13 different users who will rely on charities' GPFs for information. Users may be internal, may provide resources to the organisation, and/or seek accountability for external support such as tax relief.

2.2 Arguments against regulation

Not all users will seek information from a public register and therefore it could be argued that regulation is not required. For some donors the 'warm glow' of giving (Andreoni, 1998) will be sufficient, making them less likely to make enquiries as to charities' performance. Hyndman and McDonnell (2009) suggest that donors to street collections are likely to be in this category. Other

users may be able to demand special purpose reports from a charity (for example, philanthropic trusts and other grant makers) (Hyndman & McDonnell, 2009).

Further, charities perceive regulation in general, and financial regulation in particular, to be a burden (Burt & Taylor, 2004). As well as the direct and indirect costs of regulation, some charities may not be aware of regulatory requirements, and others may lack expertise (Burt & Taylor, 2004). For example, research following the passing of the Charities Act 1993 in England and Wales, found its imposition of reporting requirements led to a number of charities' volunteer administrators and treasurers leaving their jobs (Morgan, 2008). Although large charities are often professionalised and likely to meet (and exceed) reporting requirements (Hyndman & McDonnell, 2009), conversely, small charities may utilise their community links to communicate success, rather than formal GPFR. Thus the benefits charities and the public receive from reporting to a standard must outweigh the costs.

Yet, costs of information preparation are difficult to measure and the economic benefits of enhanced information is even more so (Brown, 1990). In respect of the Charity Commission of England and Wales, Fries (2003) explained they required a framework to encourage transparent reporting that was commensurate to the charity's size and also the public interest. Hind (2011) confirmed that the Charity Commission sought to take into account the regulatory burden on smaller charities and has simplified its forms and reduced disclosure requirements for small and medium-sized charities.

Further, charity regulators may operate unsuccessfully when they do not have clear policy goals (Breen, 2009). Breen (2009), in her analysis of fundraising regulation, notes that there are a number of models that could be used and that specific models may work best at different parts of the fundraising process. Extrapolating this theory to charity regulation in general suggests that, unless the regulator has considered all aspects of the specific activity being regulated, charities may bear regulatory costs unnecessarily if the regulator does not recognise the consequences of its actions.

An important aspect of regulation costs is the reporting requirement. Charity reporting practice has been shown to be deficient, with shortcomings in charities' GPFR being highlighted in, for example, the United Kingdom (UK) and North America as shown in the following section. Further, while the development of charity-specific standards to guide charity preparers has advanced in England and Wales (Hind, 2011), it remains underdeveloped in other countries, such as New Zealand (Cordery & Baskerville, 2007).

2.3 Charity-specific reporting

From 1960 English and Welsh charities were legally required to file GPFR, yet Bird and Morgan-Jones (1981) found that charity reporting was extremely diverse, reducing transparency and accountability. During this period the Charity Commission of England and Wales lacked resources and the accounting framework was not charity-specific.

While initially they had supported diversity in practice, Bird and Morgan-Jones (1981) found such severe inconsistencies in charity GPFR that they argued strongly for founding principles to be established and regulation to encourage compliance. From 1988 a Statement of Recommended Practice (SORP) could be used by charities to prepare their GPFR. However, a decade after the release of the SORP, Williams and Palmer (1998) explained that charities were ignorant of the SORP,

while Palmer and Vinten (1998) and Connolly and Hyndman (2001) confirmed that poor GPFR was in effect encouraged by the failure of auditors to issue qualified audit reports on non-compliant GPFR. Alternatively, Hines and Jones (1992) argued that the voluntary nature of reporting was the most likely reason for non-compliance and poor reporting practices. While complying with the SORP remains voluntary for smaller charities (with income <£25,000), it became mandatory from 1992 for medium and large charities, and this eventually drove compliance (Hyndman & McMahon, 2011). Further, the SORP is regularly updated to ensure it does not digress too markedly from UK GAAP as it is applied to the public sector, given the similarity of these organisations to charities (Hyndman & McMahon, 2011) and to ensure comparability. Practices have since improved markedly, however Palmer, Isaacs and D'Silva (2001) reported over a third of the largest 125 charities continued to file GPFR that were not compliant with the SORP.

The Charities Commission in England and Wales continues to have very little resource to undertake detailed checking of charities' filings. Morgan (2010b) noted that problems with financial reports, including that the use of different versions of the SORP, means that financial statements are not comparable across different charities, or from year to year in the same charity (although the latter is more likely). A range of non-financial reporting is also required including a Trustees Annual Report and, since April 2008, a report on the extent to which the charity has undertaken activities to accomplish its objectives for the public benefit. Recent research by Morgan and Fletcher (2011) highlighted severe inadequacies with charities' (non-financial) reporting of their achievements in this respect. Such poor financial and nonfinancial reporting is likely to undermine the public's confidence and result in fewer donations to charities, and potentially jeopardise government funding into the sector (Hyndman & McDonnell, 2009).

In Scotland, the Registrar regularly undertakes a comparative study into 'small charity accounts' using a sample of 300 charities with income under £25,000.¹ In the most recent study, they found that one in six charities produce GPFR which omit total income, expenditure and/or the resultant surplus or deficit. Approximately one in three charities files non-compliant balance sheets (Office of the Scottish Charity Regulator, 2010), although Morgan (2010b) notes that, if they do not balance, the Office of the Scottish Charities Regulator (OSCR) returns GPFR to charities prior to completing the filing.

It appears that, despite the increasing demand for transparency and accountability, there remain a number of issues in charity reporting in the UK. Users of financial statements of North American charities (and not-for-profit organisations generally) also find that financial reports filed are of poor quality.

Early research in the United States (US) by Froelich and Knoepfle (1996) compared charities' GPFR with their Internal Revenue Service (IRS) filing.² Froelich and Knoepfle (1996) noted that the most frequent misstatement was in the expense categories, where organisations shifted salaries to Cost of Goods Sold in order to understate administration expenses. However other significant errors occur in defining fundraising expenses. From interview data they found that errors in filing of the IRS 990

¹ There are approximately 25,000 charities in total registered with the Office of the Scottish Charities Register.

² Charities are defined under s.501(c)(3) of the code, may receive contributions that qualify for income tax deductions, and are regulated by the IRS.

were a result of organisations' lack of understanding of regulators' guidelines. Further, while financial statements were quite often prepared by accounting firms, the IRS 990 was filed by the organisation itself and errors indicated a lack of understanding of the financial statements within the organisation.

Keating and Frumkin (2003) note that not-for-profit organisations' filing of IRS 990's is seldom checked by the IRS regulator (around 1.3% of filings were checked in 1999). Further, filings are typically one to two years out of date and contain "high rates of mathematical errors, transposed digits, omitted information and information inserted on the wrong lines" (Keating & Frumkin, 2003, p.7). Overall, a significant minority of filings omit important documents. Keating and Frumkin (2003) highlight the difficulties of requiring organisations to fill out a form (the IRS 990) that does not comply with GAAP and requires extrapolation from GPFR into a number of pre-defined categories.

The relevance of Form 990 for users of financial statements was also raised by Froelich, Knoepfle and Pollak (2000). However, their study found higher levels of reliability of the totals in filed data than Keating and Frumkin (2003) and Froelich and Knoepfle (1996). Froelich et al. (2000) stated that balance sheet items were correct 99% of the time, income statements 90% of the time and that minor errors (+/- 10%) were unimportant. Interestingly they found that small not-for-profit organisations filed correctly more often than large organisations. This appeared to be related to the inherent relative lack of complexity. Notwithstanding the errors, Desai and Yetman (2005) noted that requiring charities to file the Form 990 was effective in ensuring that charities did not overspend charitable donations on internal compensation.

In a study of charities that submit GPFR for reporting awards in Canada, Salterio and Legresley (2010) identified that organisations with the greatest problems in developing transparent annual reports were those with revenue between CAN\$1 million and CAN\$10 million. These findings built on those of Froelich et al. (2000). They hypothesised that charities in this range had a small number of staff but that they lacked the expertise to undertake the reporting process which was complex. Smaller organisations may well have used volunteers to develop their annual report, but their organisations were less complex and therefore were more easily prepared.

Therefore, research has shown that larger organisations tend to report more transparently and meet regulators' demands more easily than small or medium-sized charities. Some suggest that small charities also meet demands better than medium-sized charities due to their simple nature (Burt & Taylor, 2004; Froelich, et al., 2000; Salterio & Legresley, 2010). However, the relative lack of expertise in small and medium-sized charities (Froelich & Knoepfle, 1996) and the voluntary nature of filing (Hyndman & McDonnell, 2009) may reduce the transparency of both small and medium-sized charities. With this in mind, the objective of this paper is to analyse how a relatively new regulator balanced its regulatory mandate with the issues raised internationally.

3. New Zealand - an emergent regulator

Calls for a charity regulator in New Zealand pre-date the Charities Act 2005 by almost two decades (Cordery & Baskerville, 2007) leading to a Charities Commission operating from early 2007. Unlike the United Kingdom which has instituted 13 charitable purposes, New Zealand chose to retain the four 'Heads of Charity' to define what entities could be registered: the advancement of education, advancement of religion, alleviation of poverty, or any other purpose beneficial to the community

(Charities Act, 2005 s.5(1)).

Registration in New Zealand is voluntary, but charities will do so in order to benefit from tax-exemption of surpluses (in pursuit of their charitable aims) and also to be able to provide a tax deduction to donors. Registered charities fund approximately 20% of the regulator's expenditure. Similar to other countries, the charities that have registered span a myriad of charitable aims, beneficiaries and size parameters. Charities are not required to take a specific legal form and may choose to be unincorporated, establish as a Charitable Trust, Incorporated Society, Limited Liability Company, or by a specific Act of Parliament. The liability of the members or 'owners' will be dependent on the incorporation chosen.

The Charities Commission was established with 13 required functions, and a Board of between five and seven members. Its main purpose is to 'promote public trust and confidence in the charitable sector' (Charities Act, 2005, s.10.1(a)). This purpose accords with the public interest theory of requiring the maintenance of the public interest.³ There have been two measures of the achievement of this purpose. In 2008, a survey found that 58% of people had 'high trust' in charities with only 7% having 'low trust' (UMR Research, 2010). However, while more people had heard of the Charities Commission in the 2010 survey, (67% of respondents compared with 57% two years before), respondents were less likely than the 2008 respondents to use the internet-based register to access charity information (Empathy & Charities Commission, 2010). Further, in 2010, only 55% of respondents had 'high trust', signalling no increase in public trust and confidence. The Charities Commission responded to this disappointing result by commissioning research into what attributes of charities cause the public to have trust in them. The results of this second survey have been shared widely with the charities sector to encourage better practice in communication and practice.

Similarly to the UK Charity Act, New Zealand's Charities Commission is also expected to 'encourage and promote the effective use of charitable resources' (Charities Act, 2005, s.10.1(b)). Charities' filings are publicly available on the internet-based register. As it has been found that organisations that make better internet disclosures of their finances fare best in the charitable contributions market (Saxton & Guo, 2011), this is an example of how the Charities Commission is informing a market for charitable donations and government funds. For example it also highlighted specific Christchurch charities which donors could support after the earthquakes that hit that city in late 2010 and during 2011. Further, it has instigated an 'open data' project that encourages software developers to mine charities' annual returns. While it allows the Charities Commission to meet one of its ancillary requirements (to 'stimulate and promote research into any matter relating to charities' Charities Act, 2005 s.10(1)(m)), it is also likely that this could result in a commentator similar to BBB's Wise Giving to establish itself in New Zealand.

The third major function of the Commission is the 'educate and assist charities in relation to matters of good governance' (Charities Act 2005, s.10(c)). This may be seen as an extension of the desire of the regulator to make charities more efficient. It is also an example of the compliance approach rather than a deterrence approach to enforcing the regulator's requirements. Since its inception the Charities Commission has attempted to inform charities through face-to-face and internet-based media. It has an active education division which works with sector leaders to extend its reach and to encourage compliance.

³ Administrative functions include the requirements to register charities and to process annual returns.

This light-handed approach is also extended to charity filings. Charities are required to file an annual return within 6 months of their year end. This is to be accompanied by a set of financial statements. While the computerised annual return has a number of boxes to complete, the GPFR can be in any format. There is no active checking of the filings.

Charities' GPFR has been previously analysed in New Zealand by Newberry (1992) who found, similarly to Bird and Morgan-Jones's (1981) UK study, that there were consistent failures in charity reporting (including expensing of fixed assets, absence of appropriate financial statements and policies). Also similar to Bird and Morgan-Jones (1981) Newberry (1992) was concerned that many of these failures had not been highlighted by the charity's auditors. More recent research undertaken by Hooper, Sinclair, Hui and Mataira (2008) and Sinclair (2011) also found charities' GPFR lacked appropriate information.

Yet unlike the UK, New Zealand did not respond to Newberry's (1992) report by developing a specific charity accounting standard or SORP.⁴ The reasons are likely to be two-fold. First there was no charity regulator at the time to champion a reporting standard. Yet, even since its establishment, the New Zealand Charities Commission has chosen not to develop its own standards. This suggests an underlying constraint related to New Zealand's 'sector-neutral' or 'transaction-neutral' approach to its financial reporting standards setting which has operated since 1994. Under this approach, for-profit and public and private nonprofit organisations have all been subject to the same financial reporting standards. Further, public sector nonprofit organisations are required to produce nonfinancial information with their GPFR, while private nonprofit organisations are encouraged to do likewise (NZ IAS-1).

The benefits of this sector neutral approach included increased comparability between organisations (for example, foundations, charities with for-profit trading arms and social enterprises). It allowed for a common understanding of accountability across all preparers, whether they were public or private, for-profit or nonprofit. Also, by taking a sector-neutral approach, standard setters' effort is minimised in respect of the small 'market' of charity reporters compared to public and private sector organisations.

Against these benefits is the drawback that New Zealand charities have been denied a regime that has been specifically developed for them. Accordingly, there are a number of charity-specific issues which are not covered by the reporting standards. These include accounting for fund-raising and the extrapolation of relevant ratios, and for tagged and untagged legacies and bequests. Explanatory advice has been developed on the treatment of these issues and this advice is linked to the current GAAP (NZ IFRS), although NZ IFRS is mandatory only for large charities with assets greater than NZ\$30million.⁵

3.1 The New Zealand research

The objective of this paper is to ascertain the impact of a light-handed charity regime on small and medium charities' reporting. This required us to access the publicly available data from charities' annual returns to the Charities Commission, as well as the GPFR charities file contemporaneously.

⁴ While a practice guide was produced for all nonprofit organisations (R100), it was a costly publication, relatively unknown and had few users.

⁵ At the time of writing, the NZ Dollar was worth 0.5 UK Pounds and 0.8 US Dollars.

This research was supported by the Charities Commission who provided raw annual return data to speed the initial process of selection and sorting of charities. They randomly selected 400 charities from their database. Two hundred of those charities had expenditure of less than NZ\$40,000 and the other 200 had expenditure between NZ\$40,000 and NZ\$2,000,000. These ranges were selected as they are the ranges for “small” and “medium” charities in future legislative changes.⁶ From this list, we selected 300 charities for further study (150 from small and 150 from medium charities), being careful to include charities that were dispersed across regions and charitable aims. Following the downloading of GPFR from the Charities Commission (www.charities.govt.nz), we checked the efficacy of the charities’ answers to the questions regarding whether the charity was using a cash or accrual basis and also the summary financial data that the Charities Commission requests. We also checked the other filings made by the charity to observe whether it complied with the charity’s rules and for any non-financial information that might aid understanding of the charities’ activities and performance. Again, we downloaded this from the Charities Commission, but where charities had not filed non-financial information, we also wrote to the charity and requested they send us any non-financial data typically provided for their members and other stakeholders (for example at an Annual General Meeting). Data received was then included in our analysis.

This research was undertaken between November 2010 and February 2011. It included charities’ GPFR for years ended 2009 or 2010 but that were filed in 2010.

3.2 Results

As noted, charities’ filings around the world have been beleaguered by errors and omissions.⁷ In this research, over 61% (184) of the 300 filings contained errors or omissions. Table 1 shows the general categories of these filing errors and the number of filings that were affected. Errors were counted as being present or not present (‘1’ or ‘0’). Therefore, where the same error occurred more than once in a charity’s filing it was counted only once, rather than as multiple occurrences.

Table 1: Errors between financial statements and Charities Commission filing

Error types	# of filings with errors
Errors in charities' filing	
Incorrect figures/figures do not match the underlying GPFR	72
Missing figures (other than above)	28
Misclassification / no separation between filing and GPFR	25
000"s missing from filing	9
Errors in charities' underlying GPFR	
Charities noted that they were filing cash based GPFR but GPFR was accrual based	77
Missing equity figures from GPFR	43
Grants disbursement as equity in GPFR, but treated as an expense in the filing.	10
Errors in addition of GPFR	2

The most common of the general errors reported in Table 1 was that the figures filed did not match the charity's GPFR (24% or 72 charities). The next most common error was missing figures, followed

⁶ See www.med.govt.nz for Framework announcement.

⁷ See for example, from the UK: Morgan (2010b), Office of the Scottish Charity Regulator (2010), and from North America (the US and Canada): Froelich and Knoepfle (1996), Keating and Frumkin (2003) and Ayer, Hall and Vodarek (2009).

by figures filed with the correct numbers, but with the “000”s missing so they were in the wrong category of small, medium or large.⁸ These errors resulted in the definitions of the charity sample changing due to the actual expenditure being different from that filed, so that the final sample included 140 small and 160 medium-sized charities (rather than 150 of each).

Froelich and Knoepfle (1996) offered the explanation for errors in US filings that the person who completes the charity filing had little or no accounting knowledge. As filing requires the charity to undertake classification and reduction of the financial statements in order to fit the required categories, if filers lack accounting knowledge errors could eventuate. One New Zealand faith-based organisation noted that 21% of their treasurers did not know whether their GPFR was cash or accrual based and 19% of their treasurers had no qualification whatsoever (a further 14% did not indicate whether they were qualified or not and 15% stated they were not qualified as accountants but had other qualifications).⁹

The form of the annual return template may exacerbate filing problems. For example, the term “gross income” created two types of errors; some charities did not disclose other income in their filings as, since the template asked for “total gross income”, they took the income after cost of goods sold figure (often called gross income), and omitted other income. This error also occurred with a filing whose GPFR had “gross income” as a separate heading to “other income” and hence “other income” was omitted. Further, some terms were ambiguous. For example, “cost of service provision” and “cost of trading operations” was interpreted by some charities as meaning the cost for them to provide their service (or for them to trade) and classified their expenses accordingly. Others interpreted it as the cost for them to receive services (or for them to receive goods). The vast majority of charities omitted figures from these two categories, disclosing separately only wages, depreciation and interest with the remainder of their expenses filed as “all other expenditure”, but it was unclear as to whether they had expenditure within this category. Keating and Frumkin (2003) found similar problems with the US Form 990 in that the filing requirements did not comply with GAAP and therefore the filer needed to ‘translate’ their GPFR to comply with the regulator’s demands.

From Table 1, GPFR errors were also significant, given that the majority of charities filed accrual-based financial statements. It can be seen from Table 1 that the most common error in this category was that charities told the regulator that their GPFR were prepared on a cash basis, when on examination of their GPFR we found they were actually prepared on an accrual basis (this affected 77 charities of the 184 who filed errors, or 25.6% of charities).

Table 2 shows more detail on where the errors lie for the 72 charities that had incorrect GPFR. It can be seen that, while there was a small number of charities that did not provide an Income and Expenditure statement or Balance Sheet, the majority of errors arose from a disagreement of particular totals (Equity in 31% of filings; Surplus/Deficit in 24% of filings). This is a much higher rate

⁸ The Charities Commission amended its form in early 2010 to charities to include dollars and cents rather than, as previously, expect them to round to the closest thousand.

⁹ Personal email to author from Van Hout.

than was found by Froelich, et al (2000) in the US where balance sheets were incorrect in only 1% of their sample and only 1% income and expenditure statements were incorrect.

Table 2: Misstatement errors by financial statement and charity size

Main filing errors reflected in GPFR	Total sample					
	Small	%	Medium	%	Total	%
Income and Expenditure statement was not filed with Charities Commission	4	2.8%	1	0.6%	5	1.7%
Gross income filed doesn't agree to GPFR	20	14.3%	32	20.0%	52	17.3%
Total expenditure filed doesn't agree to GPFR	28	20.0%	32	20.0%	60	20.0%
Surplus/deficit filed doesn't agree to GPFR	32	22.9%	40	25.0%	72	24.0%
Balance sheet was not filed	3	2.1%	1	0.6%	4	1.3%
Total assets filed doesn't agree to GPFR	22	15.7%	35	21.9%	57	19.0%
Total liabilities filed doesn't agree to GPFR	20	14.3%	23	14.4%	43	14.3%
Total equity filed doesn't agree to GPFR	40	28.6%	54	33.7%	94	31.3%
Charities filed accrual accounts but stated they were cash	34	24.3%	43	26.9%	77	25.7%

Table 2 also shows that the errors in GPFR filings by small charities are not substantially different from those of medium-sized charities. However, more than 76% of the errors in accounting basis (where charities filed accrual accounts but stated they were cash) occurred within \$120,000 in expenditure. Further, 26% of the total errors were found in charities whose expenditure was between \$0 and \$10,000.

Thirdly, we found that, although a majority (65.9%) of charities filed their returns within the deadline, these charities were likely to be medium-sized (70.5%) than small (60.8%). It can be seen in Table 3 that 102 (34.1%) of charities filed their financial statements more than 6 months after their year end. Further, we noted that 30% of small charities and almost 44% of medium-sized charities filed their financial statements in the sixth month after their year end. The high number of filings for charities during the sixth month can be explained by a last minute influx to meet the submission deadline. The high number of filings during the seventh month is likely due to charities receiving a warning letter from the Charities Commission.¹⁰

Table 3: Length of time from charity year end until filing at Charities Commission

Time in months	Small		Medium		Total in sample*	
	No.	%	No.	%	No.	%
1-3	8	5.7%	5	3.2%	13	4.3%
4-6	77	55.1%	107	67.3%	184	61.6%
7-9	48	34.3%	42	26.4%	90	30.1%
10-12	3	2.1%	4	2.5%	7	2.3%
>12	4	2.8%	1	0.6%	5	1.7%
Total	140	100%	159	100%	299	100.0%

¹⁰ Late filers could also be de-registered, but there is a lack of enthusiasm for this, given that a charity could receive the benefits of registration and then de-register and distribute its surpluses however it pleases.

* One charity had a filing date that was before their balance date

4. Discussion

The New Zealand Charities regulator appears to meet the two roles identified by public interest theory. First, it is tasked with reducing information asymmetry in order to enhance charities' accountability and therefore to increase public trust and confidence. Yet, research undertaken by the Charities Commission shows there has been a drop (or certainly no increase) in trust and confidence in charities in New Zealand (Empathy & Charities Commission, 2010; UMR Research, 2010).

Further, the sample of charity filings analysed in this project showed that filings with the regulator contain a high rate of errors, as do the GPFR that is contemporaneously filed. These errors were not limited to small charities, but were general across the whole sample. This finding is at odds with the suggestions by Salterio and Legresley (2010) and Froelich et al. (2000) who hypothesised that smaller charities may be better than medium-sized charities as they have simpler reporting needs. Although the findings are limited by the random sample chosen, these findings are more likely to show that small charities lack expertise (as shown by Burt & Taylor, 2004; Froelich & Knoepfle, 1996). This is also borne out by the informal research undertaken by Van Hout¹¹. Another factor in the lack of good quality reporting is the lack of a specific charity accounting regime, brought about by the sector-neutral focus of the accounting regulators and the paucity of advice on charity-specific matters.

However, against the similarity in small and medium-sized charities with respect to ordinary GPFR errors, of the 34.1% of charities that filed their returns outside of the required time, small charities were worse (39.2%) compared to medium-sized charities (29.5%). We noted a rush to file following the receipt of a reminder letter. Such reminder letters are dependent on the regulator's resources, yet in working with a compliance approach, the Charities Commission has chosen a method of operation which is likely to reduce the resources it has available to 'police' charities.

The light handed compliance approach (rather than a deterrence approach) used by the New Zealand Charities Commission has prioritised proactive education and balancing of costs and benefits, so that small and medium charities especially have few obligations, except to file simple reports. While this may reduce the impost of regulation on these charities, the results of the research show that the light-handed regime (which has a highly voluntary nature) has not resulted in an increase of transparency and accountability in these charities. This is likely to be a reason for the lack of an increase in the donating public's trust and confidence. While Hind (2011) might suggest that a Charity Commission is "akin to regulating angels" the compliance approach does not currently appear to be working in New Zealand. The reticence of the regulator to develop a charity-specific reporting regime and/or the slowness of the accounting regulator to do likewise is also likely to have impacted the success of the regulator in meeting its aim to develop good reporting practices.

The second reason for regulation is to create a market place (Gaffikin, 2005). By publishing the annual returns and financial information of all charities, the New Zealand Charities Commission presents data from all registered charities to any potential donor or funder. The instigation of the 'open data' project has further delivered information to software developers and those seeking to

¹¹ Personal communication with author, September 20, 2011.

mine the data which is available. In this, the New Zealand regulator has shown itself to be more proactive than other regulators, such as the Charity Commission of England and Wales that provides charity GPFR only on demand¹² and the Scottish regulator which does not publish data at all, but invites interested parties to write to the charity concerned.

A third aspect of the New Zealand regime that is not shared by UK Charity regulators is that charities share the cost of the regulator. This is likely to increase the risk that, when they have an interest in the regulator, the regulator may become captured by charities. However, although the Charities Commission does not trumpet its independence (as the Charity Commission of England and Wales does), regulatory capture does not appear to have occurred. It is likely that the diverse nature of the charities sector, the small registration fee, and the large number of users do not constitute a strong basis for regulatory capture.

5. Conclusion

There continues to be a debate about the appropriate role of regulation in the charity sector (e.g. Hind, 2011; Burt and Taylor, 2004). Regulators can represent little more than increased costs to those who are regulated, but, under public interest theory, they also reduce information asymmetry and can be used to create a more efficient charity 'market'. It appears that New Zealand's Charity Commission was established with these precepts in mind; however, this study has shown that the light-handed nature of regulation has not resulted in the regulator achieving its aims. There are high levels of asymmetry in the GPFR reporting, as shown by the errors in the filings made by charities and therefore the aim to inspire public trust and confidence is not being met, nor are a significant minority of charities being accountable to their users.

Similar problems with the reliability of charities' financial reports have been highlighted in a number of jurisdictions. There is a lack of GAAP-compliant GPFR filings, with charities regulators. Filings lack totals and segmentation especially where expenses and revenues are sensitive (e.g. fundraising). Sinclair (2011) suggests this can be attributed to charities' desire to "look poor". A second argument is that charities lack expertise to file appropriate financial statements. There is little research on capacity in this area, and it would be useful to extend this research with qualitative data on capacity and willingness to complete regulatory filing, not only in New Zealand, but also internationally.

The New Zealand Charities Commission has developed methods to market charities to donors and thus has prioritised the marketplace rather than the reduction of information asymmetry. However, due to its light-handed approach, the information it provides to this market is likely to be flawed and undermine its position as a regulator. The findings of this research show how necessary it is for charity regulators to utilise minimum reporting standards, and/or to utilise deterrence methods rather than light-handed compliance methods, to increase the likelihood that charities will discharge their accountability in a transparent manner.

¹² However, the Charity Commission's 2010/11 annual report notes that it is reviewing how it publishes and shares information on charities.

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