New accounting standards framework for charities

Firstly, don't panic, these changes are some way off and most of the proposed new standards have not yet been developed. The proposed timetable for implementation is detailed in a later section of this article.

What is the current framework?

New Zealand Equivalents to International Financial Reporting Standards (NZ IFRS) are the General Accepted Accounting Principals in New Zealand. Entities which qualify for differential reporting can elect to defer the implementation of NZ IFRS and instead report under "Old GAAP".

For most of Trust Management's clients which are not deemed to be large, the charity has elected to defer NZ IFRS and report under Old GAAP.

It is important to note that presently there is no requirement in the Charities Act 2005 or the Financial Reporting Act 1993 for charities to comply with any accounting standards.

Changes afoot

There are a number of changes occurring in tandem at present.

The Ministry for Economic Development ("MED") is considering amendments to require charities of a certain size to have mandatory audits undertaken. See our Resources Page for Trust Managements submission to the MED.

The Financial Reporting Act 1993 is also being reviewed, and the Financial Reporting Bill 2012 has been introduced. This Bill if passed would require registered charities to prepare General Purpose Financial Reports ("GPFRs").

The External Reporting Board ("XRB") is also introducing a new set of accounting standards and framework for Public Benefit Entities ("PBE's"). This framework is described below.

What is the proposed framework?

The first step is to determine whether your charity is a for-profit or public benefit entity. If you are not a public benefit entity, you are deemed to be a for-profit entity. The definition of a public benefit entity is;

> *"A reporting entity 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".*

Depending upon your classification of for-profit or PBE, you will then apply accounting standards per the table over the page, based upon the size of your entity.

Is your charities primary objective to provide goods or services for community or social benefit and has the charities equity been provided with a view to supporting that primary objective rather than for a financial return to equity holders?

NO

For-Profit Entities	Accounting Standards Framework
Large (2 or 3 criteria) • Assets $10m • Revenue $20m • Staff 50+	Full NZ IFRS
Not large	Reduced Disclosure NZ IFRS

YES

Public Benefit Entities	Accounting Standards Framework
Large expenses greater than $30m	Full PBE
Not large, expenses greater than $2m	Reduced Disclosure PBEs
Not large, expenses less than $2m	Simple Format PBEs (accrual basis)
Not large, eligible for cash accounting[1]	Simple Format PBEs (cash basis)

[1] Yet to be defined

Unsure of whether your charity is a Public Benefit Entity?

Charities which are currently applying NZ IFRS will have already determined whether their charity is a for-profit or public benefit entity pursuant to NZ IAS 1. Though these charities may wish to re-evaluate their classification in light of the changes ahead.

For those charities which have not yet grappled with the classification, the answer will either be very straight forward or as grey as an English summer.

If your charity directly provides goods and services to the community, and your charity has no commercial activity, your charity will clearly be a Public Benefit Entity.

If your charity is an "endowment trust" whereby you give money to other charities to provide those services, or your charity operates a business to raise funds for its charitable purpose, the classification will be less clear.

Conflicting indicators

The accounting standards acknowledge in some cases indicators of whether an entity is for-profit vs public benefit may conflict with each other in respect of a single entity and the primary purpose or objective of the entity may not be obvious. Some indicators may indicate that an entity should be classified as profit-oriented and others may indicate the entity should be classified as a public benefit entity. In this situation professional judgement is required.

The following is an example from the guidance note to NZ IAS 1 will clearly illustrates the considerations Trustees will need to weigh.

Scenario : Charity shop

A charitable trust is established with objective of providing health services to the homeless. The trust receives an annual grant from the Government. The grant is sufficient to cover operating costs necessary to provide basic health care services to a limited number of people. To meet the increasing demand for its services and to fund an expanded range of services, the trust establishes a charity shop (Company 1).

Company 1 sells second hand bicycles and runs a successful bicycle hire service. All profits from Company 1 are returned to the trust to support the primary objective of providing health services to the homeless.

- ***Founding documents - Constitution***

Company 1's constitution specifies that its objective is to raise funds to support the charitable trust.

- ***Nature of the benefits***

The benefits derived from Company 1 are the funds generated through the sale and hire of bicycles. This may indicate that the shop is a profit-oriented entity. If on the other hand the shop is used primarily as a vehicle to promote and publicise the objective of the trust or to provide employment to homeless people, then Company 1 may, subject to consideration of other factors, be a public benefit entity.

- ***Quantum of the expected financial surplus***

The directors carefully manage Company 1 to ensure it meets its financial targets. The directors are experienced business people who donate their time to manage and guide the operation of Company 1. The directors aim to ensure that the return on the net assets invested in the shop is at least equivalent to a market return. If Company 1 does not generate adequate return the directors may recommend that the trust invest its funds in another activity. This may indicate that Company 1 is by nature an investment and therefore profit oriented.

If Company 1 was operated with the objective of generating a positive financial return and the level of the return was not determined with reference to market returns, the shop may be a public benefit entity.

- ***Nature of equity interest***

In the situation described Company 1 is a company 100% owned and controlled by the trust. As such the ownership instrument is clear. In the event Company 1 ceases trading the trust is able to determine how to use any residual assets. This may indicate that Company 1 is profit oriented.

An example of the nature of the equity interest for a public benefit entity is where a trust deed requires that in the event the entity ceases operating, any residual assets are to be applied to another entity with a similar purpose. The use of the assets is restricted and no individual can benefit privately from the assets.

- ***Nature of funding***

Company 1 raises revenue through the sale and hire of bicycles. Company 1 also serves as a collection point for donations to the trust. Such donations are not the property of the shop and are banked into a separate trust account controlled by the trust.

Given the objective of Company 1 is to maximise return, the sale and hire of bicycles must be at market rates. This would indicate that the entity is a profit-oriented entity.

Which set of accounting standards will be more applicable

If a charity can be classified as either for-profit and public benefit entity, the Trustees should make the determination of the classification based upon the primary purpose of the entity, rather than which accounting standards it will then need to apply.

That said, in the case of large charities which would be required to implement NZ IFRS if the determination was for-profit, Trustees may consider whether these accounting standards are more geared towards financial institutions and large companies, resulting in a high number of unnecessary disclosures in the notes to the accounts.

However, full Public Benefit Entity accounting standards could very well head the way of public sector accounts with additional disclosures such as statements of service provision. Though it is difficult to know with certainty until the standards are released for comment.

The when, where and how's of accounting standards for Public Benefit Entities

Though not shown in the table for simplicity's sake, Public Benefit Entities are further divided between not-for-profit PBE's and public sector PBE's.

Accounting Standards for tier 1 and 2, public sector PBE's were released for comment and submission on 28 June 2012. Though the accounting standards for tier 1 and 2 not-for-profit PBE's are not due for release until mid 2013 with submission due early 2014, these are not likely to differ greatly from the public sector PBEs.

With respect to simple format reporting of tiers 3 and 4, these accounting standards will be released for comment and submission from late September 2012, with submissions due late April 2013.

Our advice is that if your charity is a not-for-profit tier 1 or 2 PBE you should read the public sector PBE accounting standards as a preview of what is likely to come.

So when do the accounting standards become effective?

For not-for-profit PBE's the targeted effective date of the new accounting standards is for reporting periods on or after 1 April 2015.

For-Profit entities the target date for Reduced Disclosure Reporting is November 2012, though this will be in conjunction with the passing of the new Bill.

Summary

The majority of Trust Management's clients are either Public Benefit Entities (where goods and services are being directly applied to charitable purposes) or will have some discretion about their classification between a Public Benefit Entity or a For-Profit entity (where a charitable trust is an "endowment trust" and provides distributions to other charities).

For-Profit entities will either report under full NZ IFRS if they are large (in which case it is likely they have already adopted full NZ IFRS), or NZ IFRS - Reduced Disclosure Reports if they are not large.

Clients which are PBE's will likely prepare either simple format reports on an accrual basis or Reduced Disclosure PBE reports depending on the size of their expenditure.

This article has largely been prepared for the benefit of Trust Management's clients. The article summarises several components of the proposed changes and legislation, for a more comprehensive analysis of the effects of these changes on your charity, please do not hesitate to contact us.