



Financial reporting by New Zealand charities: finding a way forward

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Abstract

Purpose – Charities are becoming recognised as playing an important part in communities by furthering government's social objectives through increasing support to disadvantaged members of society. As charities multiply in number, it becomes increasingly difficult for fund providers and contributors to determine which charity to support. In New Zealand there is a move towards providing public access to the financial accounts of charities to assist stakeholders in their decision making and to enhance transparency in charities. However, this assumes that these financial accounts are understandable by all stakeholders. This paper aims to identify four problems that limit the way forward for financial reporting by New Zealand charities.

Design/methodology/approach – The first section of the paper comprises a review of the literature on charities' financial accounts with a particular focus on the four problems identified above. The paper then reports the results of eight interviews with charitable organisations, auditors and academics that have expertise in charity financial reporting, with a particular emphasis on the four identified problems.

Findings – There was agreement that unresolved, these four problems could limit the way forward in financial reporting by New Zealand charities. Some recommendations are proposed that suggest a way forward with regard to these problems, so that the users of the financial reports of charities may benefit.

Research limitations/implications – Highlights a need for further research into these problems to identify the feasibility of the proposed recommendations.

Originality/value – The enactment of the Charities Act 2005 in New Zealand and its requirement to include financial accounts on a publicly available register has raised the profile of the financial reports of charities. However, there has been limited research into the financial reporting by New Zealand charities, so this paper is a timely evaluation of four specific problems that could limit the way forward of financial reporting by New Zealand charities.

Keywords Charities, Accounting, New Zealand, Non-profit organizations

Paper type Research paper



Introduction

There are thousands of organisations worldwide that call themselves charities and every day these organisations call on the general public and businesses with pleas for donations for their worthwhile causes. Determining which charity to support is becoming an increasingly difficult dilemma for the public.

One way in which stakeholders can determine which charity to support is through their financial reporting. This has been reflected in New Zealand with a move towards

making these publicly accessible in order to enhance the transparency of charities and improve public confidence (Charities Commission, 2006d). This assumes that the financial accounts of charities are understandable and transparent. Unfortunately, previous studies (Bird and Morgan-Jones, 1981; Hyndman, 1990; Hines and Jones, 1992; Newberry, 1992; Williams and Palmer, 1998; Connolly and Hyndman, 2000) have shown that this is not the case and that there are some serious problems with the understandability of the financial accounts of charities. We identify four problems (discussed below) which need to be resolved or their impacts lessened to ensure the financial accounts of charities find a way forward. For, as noted by the Charity Commission (2004, p. 2) in the UK, “easy access to accurate and relevant information about charities is essential for real accountability and for trust and confidence in charities.”

Importance of the New Zealand charities sector

The not-for-profit (NFP) sector, of which charities is an important part, is a large and important one in New Zealand and provides crucial services to our communities (Fisher, 2006). The New Zealand Government considers that the NFP sector assists them in furthering their own social objectives through, for example, increasing support to disadvantaged members of our society (Cullen and Dunne, 2006).

The New Zealand Government is trying to quantify how large the NFP sector is, as the New Zealand system of national accounting does not measure voluntary activities so the true size of the NFP sector is hard to determine (Statistics New Zealand, 2006). The United Nations is also interested in measuring the NFP sector globally and to assist this has published a handbook which recommends statistical methods on which to measure data on NFP institutions (United Nations, 2003). Currently 22 countries, including New Zealand (Tennant *et al.*, 2006), have committed to implementing part of the handbook (United Nations, 2006) showing that having a better understanding of the NFP sector is of global importance.

The New Zealand Minister of Finance and the Minister of Revenue estimate that there are 90,000 NFP organisations within New Zealand, who in 2005 received an estimated \$356 million in donations from individuals (Cullen and 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 charities.

The literature

Definition of charities

One of the issues when researching the charity sector is the profusion of nomenclature employed to represent the sector. These include: not for profit, incorporated societies, public benefit entities, donee organisations and charities. It is therefore important that the meaning of charities is clarified before their problems are discussed.

NFP can be defined as any organisation that is:

... not carried on for the profit or gain of any member and has rules that do not allow money, property or any other benefits to be distributed to any of its members (IRD, 2005a, p. 1).

Charities are a smaller subset in the NFP sector. The NFP sector can also be split into other components which do not clearly delineate charities. First, NFP organisations can

be either unincorporated or incorporated. Incorporated societies must meet the definition of Section 4 of the New Zealand Incorporated Societies Act 1908, which states that they must consist of more than 15 persons and not be for pecuniary gain.

Secondly, the United Nations defines NFP organisations as those meeting five criteria:

- (1) has an organisational structure;
- (2) NFP;
- (3) institutionally separate from government;
- (4) self-governing; and
- (5) non-compulsory (United Nations, 2003, p. 17).

As can be seen in Table I, NFP institutions are then split into the following categories, some of which would be relevant to charities (Statistics New Zealand, 2006).

Public benefit entities is the term used in the New Zealand International Accounting Standard (IAS) 1, paragraph 11.2, where public benefit entities are defined 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 (NZICA, 2004a, p. 12).

As with NFP organisations, charities are a smaller subset of public benefit entities.

Another meaning that overlaps is “donee organisations” (Cullen and Dunne, 2006). These are organisations in which individuals who donate gifts of money to them are entitled to a taxation rebate. Donee organisations are defined in section KC 5 of the New Zealand Income Tax Act 2004.

Finally, the definition of charity originally comes from the common law test for charitable purpose contained in the judgement by Lord Macnaghten in *Income Tax Special Purposes Commissioners v. Pemsel* (1891). He classified charitable purposes into four categories (Charities Commission, 2006a) and (Ministry of Economic Development, 2005):

NFP categories	New Zealand example
Non-profit service providers: education and research	Kohanga Reo
Non-profit service providers: health	Plunket society
Non-profit service providers: social services	Barnardos New Zealand
Non-profit service providers: environment	RNZSPCA.
International aid and relief organisations	World vision New Zealand
Arts and culture organisations	Repertory theatres
Sports clubs	NZ Rugby union
Advocacy groups	Automobile association
Philanthropic trusts	ASB community trust
Community-based or grass-roots associations	A&P associations
Tangata Whenua-based organisations	Marae committees
Political parties	NZ labour party
Social clubs	RSAs
Unions, business and professional associations	NZ Bankers Association
Religious congregations	Anglican Church

Table I.
Categories of NFP
institutions

- (1) advances education;
- (2) advances religion;
- (3) relieves poverty; or
- (4) is otherwise beneficial to the community.

This is also embedded in section 5(1) of the New Zealand Charities Act 2005 which 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.”

Finding a way forward for charities' financial accounts

In New Zealand, the Minister of Finance and the Minister of Revenue feel that increases in the accountability and transparency of charities will improve public confidence (Cullen and Dunne, 2006). To enhance the transparency of the charities sector, the government considers that registering charities will provide the public with greater confidence (Saywell, 2006). This has seen the enactment of the Charities Act 2005, which in Section 24 details the information required on the charities' register including an annual report. The draft annual report form requires charitable entities to provide a copy of its financial accounts (McLay, 2006). The New Zealand Minister of Commerce says that financial reports will need to be provided regardless of the income level of the charity (Wilson, 2004). As an incentive to ensure charities register, only registered charities will retain their income tax-exemption status (Charities Commission, 2006b). The importance of financial accounts in making decisions has been shown in the UK where a survey of 1,000 people was conducted by the Charity Commission (Framjee, 2004, p. 89) where 60 percent of respondents felt that, “the ability to compare important information between charities would affect their decision about which charity to support.”

In New Zealand, where there has been little supervision of charitable entities (McLay, 2006) and to further enhance accountability a Charities Commission has been set up. Their role, as well as setting up the registration of charities, is to monitor annual returns submitted by charitable organisations which the government believes will assist in promoting public trust and confidence in the charitable sector (IRD, 2005b). This will, hopefully, ensure that charities will not be let down by their trustees (Siveter, 2004). This means that trustees will have to start behaving and acting appropriately and thereby further enhance public confidence (Siveter, 2003).

The financial accounts which form part of the annual report will be available to the general public under Section 28 of the Charities Act 2005. Raising to prominence the financial accounts of charities will further press the requirement for accounts that are understandable and transparent to potential donors who may view the Charities Register to obtain information about a particular charity. Such wider public dissemination highlights the need to clarify some of the ambiguities in charity accounts, especially those identified by previous studies (Bird and Morgan-Jones, 1981; Hyndman, 1990; Hines and Jones, 1992; Newberry, 1992; Williams and Palmer, 1998; Connolly and Hyndman, 2000).

Problems limiting the way forward

The American Accounting Association (AAA, 1966) and the Accounting Standards Board (ASB, 2005) in the UK define accounting as being concerned with the provision of economic information to permit informed judgements and economic decisions by the users of information. Hyndman (1990) identified two main users of charities' financial accounts: resource providers – funding bodies (like the government) – and contributors – those among the general public who donate to charities. However, accounting standard bodies like the Financial Accounting Standards Board (FASB, 1980) in the USA focus their reporting requirements on resource providers rather than contributors (Hyndman, 1990). When developing their NFP financial reporting guide in New Zealand, the New Zealand Institute of Chartered Accountants (NZICA, 2006, p. 103) also focused on the need to demonstrate accountability to external users such as funding providers. Hyndman (1991) considers that accountability to contributors is not discharged in the most effective manner so as to provide appropriate information to contributors and that charities should be more aware of contributors' needs. Moreover, Hyndman's (1990) study of 156 contributors indicates that the information that contributors consider important is generally not disclosed.

The Charities Commission (2006c) identifies thirteen stakeholder groups including the general public, local government, businesses, professional advisors, community and voluntary sector groups which, in various ways, support charitable institutions. At present, the information provided in charities' financial accounts focuses on meeting the needs of funding providers, while not necessarily addressing the requirements of other stakeholders. This issue was explicitly highlighted by NZICA (2005) who considered that further research needs to be undertaken on identifying stakeholder information needs.

In the UK, the Charity Commission interprets transparency and accountability as "providing relevant and reliable information to stakeholders in a way that is free from bias, comparable, understandable and focused on stakeholders' legitimate needs" (Framjee, 2004, p. 89). It is therefore important to clarify the transparency of financial accounts which will increase the accountability of charities to both contributors and resource providers, by ensuring that there is sufficient information for all stakeholders of the financial accounts to base their opinion on.

The most significant research that looked at the transparency of the financial accounts of charities was Bird and Morgan-Jones (1981). They analysed the accounts from 85 large fund raising charities in the UK and identified a number of weaknesses in the accounts of charities including: the format of accounts; the treatment of legacies; the treatment and disclosure of expenses; the use of fund accounting; and the treatment of fixed assets.

With the advent in New Zealand of publicly accessible financial accounts of charities, a preliminary study was undertaken to determine whether some of the weaknesses identified in Bird and Morgan-Jones (1981) also applied in New Zealand. The study focused on four areas of ambiguity:

- (1) fund accounting;
- (2) treatment of fixed assets;
- (3) accounting basis; and
- (4) fund raising expenses.

The problems with fund accounting

Fund accounting is commonly used in charities and is a system of separating assets, liabilities, equities, revenues and expenditures into several different entities (Wacht, 1991, p. 71). These funds “are like a collection of cookie jars” (Herzlinger and Sherman, 1980, p. 8) where monies for different activities are stored separately and you can only eat, i.e. use the appropriate cookie, for a specific purpose. Such separation could be the result of a donor imposing restrictions on the funds that they contributed.

Herzlinger and Sherman (1980, p. 96) support the use of fund accounting in charities on the grounds that:

... the fund accounting statements provide three essential pieces of information on resources: their purpose, the legal limits on their use attached by the donors, and the revocable decisions made by the board on their use.

They believe that fund accounting is a vehicle through which the trustees of a charity can fulfil their legal obligation as to the use of the contributed funds according to the restrictions imposed by donors. Unlike business accounting, any unspent restricted funds may have to be returned to the donor or be maintained in the restricted fund for re-use for the original purpose (Herzlinger and Sherman, 1980).

Problems with fund accounting include:

- (1) different titles to describe similar funds (Bird and Morgan-Jones, 1981);
- (2) money being transferred illegally among funds (Herzlinger and Sherman, 1980); and
- (3) stakeholders not understanding the difference between surpluses and funds, such as where surpluses can be used without restrictions whereas some funds must be used for the purposes for which they were created.

Moreover, the complexity of fund accounting is further demonstrated by NZICA (2006) who identify eight accounting treatment for different types of bequests/funds.

New Zealand’s Statement of Concepts (NZICA, 1993) does not mention fund accounting practices and the *Glossary* recently released by the Charities Commission (2006e) also has no definition of funds. There is in fact little attention paid to fund accounting in New Zealand despite some charities using differing forms of fund or reserve accounting (Newberry, 1992). In fact, Walker (2004) refers to fund accounting in New Zealand as the perennial problem.

The problem with fixed assets

Fixed assets are tangible assets that have future economic benefits controlled by an organisation (NZICA, 1993). The balance sheet of a charity should reflect all assets that are under the control and responsibility of a charity (Bird and Morgan-Jones, 1981). The question is whether fixed assets purchased by a charity or gifted to a charity should be capitalised and depreciated in accordance with generally accepted accounting practice.

In the UK, Bird and Morgan-Jones (1981) surveyed 85 large charities to discover that some charities do not depreciate their fixed assets. Other charities write-off assets on purchase and many others do not disclose their depreciation policies. The immediate write-off of fixed assets to revenue account and the omission of fixed assets from the balance sheet do not give a true and fair view of the charity’s financial position at the year end. Even among the charities that do depreciate their fixed assets, the fixed

assets are often not depreciated consistently over their useful lives. With regard to the depreciation of fixed assets acquired by gift, Bird and Morgan-Jones (1981) believe that they should be treated in the same way as those fixed assets acquired by purchase. Hines and Jones (1992) conducted a longitudinal study of 40 large UK charities' reporting practices from 1988 to 1990, and discovered that there are still charities who do not depreciate their fixed assets, which is not in compliance with the UK's Statement of Recommended Practice (SORP) (Charity Commission, 2005).

Hines and Jones (1992) suggest several possible reasons why charities do not depreciate their fixed assets:

- If capital assets are purchased by using the donee contributions, there is no cost to the charities. Therefore, there is no need to cover the cost from revenues and no depreciation charge is needed. This argument assumes that the fixed assets will either not be replaced or when they are, there will be a fresh set of willing donors.
- Charities may feel that depreciation is not consistent with fund accounting, which reflects a receipts and payments situation since depreciation is an expense not a payment.
- Charities may feel that fixed assets are provided by past generations for current capital needs, so future needs should be provided by future generations. There is therefore no need for the current users to provide for depreciation.
- Charities prefer to expense fixed assets at once because it would reduce their reported surplus and the level of fixed assets held. This would portray an appealing image of a lack of funds. It may be argued, however, that an impoverished image may also be achieved by capitalising their fixed assets and then depreciating them to reduce income.

It is of interest to further investigate why the charities are not willing to depreciate their fixed assets as a normal practice. Williams and Palmer (1998) conducted a survey of 83 UK charities' accounts by using Bird and Morgan-Jones's (1981) survey as a benchmark. Williams and Palmer (1998) conclude that there are considerably more charities capitalising and depreciating their fixed assets than those surveyed by Bird and Morgan-Jones (1981). For those charities who do not depreciate their fixed assets, their reasons (Williams and Palmer, 1998, p. 276) are:

- the assets were being maintained at their "current condition" and so they were not depreciated; and
- the charity was confident that capital grants would be available to replace the assets.

Similar weaknesses in fixed assets reporting were found in New Zealand charities. Newberry (1992) surveyed 29 charities which provided audited financial reports and found that four charities were not following the appropriate accounting standard. The unacceptable practices are:

- Fixed assets are not capitalised and are written off as expense immediately.
- Fixed assets purchases are deducted from net assets and the amounts actually purchased are not disclosed (What the debit and credit entries could be to reduce

total assets by deducting assets purchased continues to puzzle us but apparently it is done).

The acceptable accounting practice is to recognise fixed assets purchased or donated is to:

- (1) capitalise; and
- (2) depreciate them as appropriate over their useful life (NZICA, 2006).

The problem with the accounting basis

The third problem relates to the accounting basis used. Generally, accounts of an entity are prepared on either a cash basis or an accrual basis. Where donations are received the basis should be cash rather than accrual basis as large amounts of donations could be pledged but only a few pledges honoured. This was the case with the 2004 Boxing Day tsunami where the United Nations only received a tenth of what had been pledged (Radio New Zealand, 2005). Bird and Morgan-Jones (1981) suggest that in between a cash basis and an accrual basis, there are two other accounting bases, a modified cash basis (receipts recorded on a cash basis, expenditure on an accrual basis), and a modified accrual basis (revenues recorded mainly on an accrual basis but some on a cash basis). The accrual basis is a fundamental accounting concept in preparing financial reports. Financial reports prepared on an accrual basis inform users of the transactions involving not only the payment and receipt of cash during the period reporting, but also the obligations to pay cash in the future and the resources that represent cash to be received in the future.

The problem with fund raising expenses

Finally, there is often ambiguity over the treatment of fund raising expenses. Donors may be concerned to know what proportion of funds raised are taken for general overheads, particularly with regard to specific purpose funding. Some charities are very transparent about this, for example, Care Foundation, a New Zealand charitable trust which focuses on child safety, confirmed that they kept 75 percent of donations for overheads with consequently only 25 percent going to beneficiaries (Henderson, 2002). For many fund raising charities the problem is how overheads should be allocated to fund-raising projects and what is an appropriate benchmark.

Research questions and methodology

We identified eight research questions which related to the four problems:

(1) Fund accounting:

RQ1. Should a standard terminology be used for different types of funds?

RQ2. Do you agree with categorisation of funds generally into unrestricted and restricted?

RQ3. What motivations do charities have to establish funds?

(2) Fixed assets:

RQ4. How should the fixed assets purchased be treated in a charitable organisation?

RQ5. Should fixed assets purchased be depreciated?

RQ6. Should fixed assets donated be treated in the same way as those fixed assets purchased?

(3) *Accounting basis:*

RQ7. Should charity accounts be prepared on an accrual basis, cash basis or modified appropriately?

(4) *Fund raising expenses:*

RQ8. How should overheads be allocated to fund-raising, especially with regard to specific fund raising events?

The eight research questions were investigated through interviews. We decided that interviews were the most appropriate research approach as it would provide the best possible understanding of the problems. The interviews were conducted in the interviewee's office in order to allow the researcher and the participant interacting with each other freely, to develop unexpected themes. The research consisted of eight in-depth interviews. These were conducted with two charitable organisations, three auditors and three academics that have expertise in charity financial reporting. The qualitative research principle is that interviews are carried on until each research problem is "saturated" (Morse, 1995).

The following section will present the interview outcomes as identified:

- fund accounting;
- treatment of fixed assets;
- accounting basis; and
- fund-raising expenses.

Interviews outcomes

The problems with fund accounting

There is still a lack of consistency in the titles used. The two auditors interviewed concur that charities use many different titles of funds to account for funds for different purposes. The most common titles used are general fund, accumulated fund, capital fund and endowment fund. One auditor describes this type of fund accounting as "jam-jar accounting" to reserve funds for a different purpose which is similar to the view of Herzlinger and Sherman (1980). The Chief Financial Officer (CFO) of one charitable organisation cites an example that titles of funds may have different definitions in different charities. One charity uses designated funds which mean 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. This lack of consistency in terminology leads to confusion for the different users of the financial reports.

The reasons for establishing funds suggested by the interviewees are quite diverse. The CFO of one charity said that "some charities may have a motivation to try to confuse the readers of the accounts" by transferring money into specific funds and beyond public scrutiny so as to strengthen appeals to potential donors on the grounds

of urgent need. For example, sometimes money is transferred from general fund to specific fund to make the charity appear short of funds. He acknowledges that this practice is not good, but it is nevertheless what some charities do.

It should be appreciated that fund accounting is a particular type of accounting that is different from commercial practice which could make it harder for the user, who is unfamiliar with charities accounting, to understand. The lack of specific terminology in New Zealand means that the use of fund accounting in charity financial reporting becomes a charity's choice. The titles of funds presented in the financial statements, therefore, largely depend on the professional judgment of the preparers. This gives rise to the proliferation of different terms to describe similar types of funds, which in turn causes confusion to the users of the financial accounts.

In defence of fund accounting, Herzlinger and Sherman (1980, p. 104) argue that the problem of the complexity of fund accounting is not resolved "by simplification but by better education of users about the meaning and purpose of the components of a fund accounting statement and by greater accessibility to these statements." However, if the financial statements of a charity are too complex to comprehend, the interest of the stakeholders in the charity reports would be discouraged. Making financial reporting too complicated to understand might minimise the motivation of the information users to look at the charity accounts for decision making purposes. To clarify this, it is proposed to determine whether the format originally recommended by Bird and Morgan-Jones (1981) would provide transparency. Bird and Morgan-Jones (1981) proposed to separate funds into unrestricted fund, restricted fund, building and equipment fund and endowment fund.

The problem with fixed assets

The study indicates that all interviewees (100 percent) agree that fixed assets should be treated in compliance with financial reporting standards. This means that fixed assets purchased by a charity should be capitalised and depreciated over the asset's useful life. One academic further suggests that fixed assets should be revalued annually and be subject to an impairment test by comparing their net book value and their net realisable value. Impairment loss should be charged to the income account in compliance with the *New Zealand International Accounting Standard 36* (NZICA, 2004b).

However, many of the interviewees do comment that some charities, particularly the small charities, are not capitalising their fixed assets. These charities are more focused on receipts and payments: where the money comes from and what they spend it on. The CFO of one charity condemns as unacceptable practice what is, in effect, immediate 100 percent depreciation. Bird and Morgan-Jones (1981) also confirm that many small charities only use receipts and payments accounts. This practice contravenes the New Zealand NFP reporting guide paragraph 4.108 (NZICA, 2006), which states that all property plant and equipment be measured at cost or, if donated, measured at fair value.

In relation to fixed assets donated, there is a consensus amongst the interviewees that the fixed assets donated should be treated in the same way as those fixed assets purchased. One academic believes that whether fixed assets are purchased or donated, they "comprise an integral part of the financial position" of a charity. Another academic further stresses that the assets donated should be separately labeled to

differentiate them from those fixed assets purchased by the charities themselves. The donors may put such restrictions on the donated fixed assets that they cannot be sold. Generally, no reasons have been identified to justify that the fixed assets donated should be treated differently from the fixed assets purchased.

In response to the proposition from some charities that fixed assets kept in good condition need not be depreciated (Williams and Palmer, 1998), most of the interviewees felt that such a proposition was not justified by the principle of allocating the cost of the assets over their useful life. One interviewee added that accounting for depreciation follows the matching principle that the cost of purchasing a fixed asset spreads over the period in which it is expected to generate revenue. It assumes that under normal circumstances, assets are worn out at the end of their useful life except buildings which might appreciate over time; whereas in some cases, fixed assets become impaired or even obsolete due to technological advancement. Another interviewee suggests that where the fixed assets are being maintained at their current condition, the charity should estimate their useful life longer rather than choose not to depreciate them.

One auditor points out that some charities may get confused between depreciation and cash flows. Depreciation is an accounting treatment of consuming an asset, whereas replacement of an asset depends on the availability of cash flows. Therefore, the argument from some charities that capital donations would be available to replace the assets was not accepted (Williams and Palmer, 1998). One auditor also pointed out that expecting a capital donation involves uncertainty and that is a fairly aggressive financial strategy. Other interviewees added that the realisation of an uncertain capital donation is a windfall gain rather than a long-term financial strategy.

The problem with the accounting basis

There are diverse opinions amongst those interviewed as to whether the financial accounts of charities should be prepared on a modified accrual basis. However, some 62 percent of interviewees agree to the use of a modified accrual accounting basis in preparing financial reports of charities. The remaining interviewees (38 percent) oppose the use of a modified accrual basis for the reason that only an accrual basis can reflect a true and fair view of the charity's financial results and position.

Most of the interviewees who support the use of a modified accrual basis recognise the difficulty in enforcing payment of donations that are promised by the donors. One auditor emphasises that they are just promises and donors consider that there is no contractual obligation for them to pay. These promises are uncertain and unreliable. There is no guarantee that donations promised would be received in the future. When the charity is certain that these promises are reliable and measurable, these promised donations should be accounted for on an accrual basis. For example, in some cases where money has been spent on a particular project anticipating that income of donations will be effectively coming, such income should be accounted for on an accrual basis.

One CFO considered that whether the accounts of charities should be prepared on an accrual basis depends on the size of a charity. For a large charity, accounts should be prepared on an accrual basis, whereas for a small charity, accounts should not necessarily be prepared on an accrual basis. He continues by giving examples to illustrate the inappropriateness of adopting an accrual basis in preparing charity accounts in some circumstances. For example, a charity is informed by the executors of an estate that the charity is going to receive some money from the estate on the

conditions that the surviving spouse and all the children have passed away. This may occur 50 years later. If this income is accounted for on an accrual basis, it would distort the financial position of the charity as the accounts receivable would not be settled in the near future. Another example is that as a result of an appeal to meet the target for the year, a special donation is received by a charity close to the end of the financial year. That income is not going to be spent until the following financial year, so in principle, that income should be accounted for as deferred income on an accrual basis. The CFO, however, comments that using accrual accounting in such a situation does not add any value to the organisation or the users of the financial statements. A modified accrual basis might be appropriate to account for income received during the reporting period. The CFO further suggests that there may be a number of financial reporting standards to prescribe a separate treatment for charities under certain circumstances.

One trustee of a charity comments that when a charity adopts a modified accrual basis in preparing its accounts, notes to accounts should be disclosed to inform the users of the revenues that have not been accounted for in the period reporting either as deferred or accrued income. An academic interviewed suggests that a materiality test should be used to determine whether to use a cash basis or an accrual basis in preparing charity accounts.

The problem with fund raising expenses

Views from those interviewed ranged from not allocating to fully allocating the overhead of administration costs to fund-raising projects. Two interviewees (25 percent) believe that there is no need for allocating administration costs to fund-raising projects as they are the costs of running the charity as a whole. The administration costs are incurred regardless of fund-raising activities. Four interviewees (50 percent) suggest that allocating the administration costs to fund-raising projects would be appropriate to inform the contributors of the “fair cost of a fund-raising activity.” This practice of cost allocation follows the matching principle. Two interviewees (25 percent) argue that allocating overheads is problematic in financial reporting. It depends on which method of overhead allocation a charity chooses to adopt and the method chosen is usually “unverifiable.”

Finding a way forward for charities’ financial reporting

To find a way forward for charities’ financial reporting, the four problems identified need to be resolved or their impacts lessened in order that informed judgements and decisions can be made by the users of financial information.

Fund accounting

With regards to fund accounting, the study found that charities use many different titles to depict funds, indicating a need for standardised terminology to account for the different titles of funds to enhance comparability and consistency. This terminology needs to be clearly understood by the users of the financial reports.

The majority of the interviewees responded favourably to the suggestion of standard terminology to account for the different titles of funds. The reasons supporting their views are:

- identifying clearly the purpose of the funds;
- directing managers to apply funds as specified by donors;

- assisting managers to make decisions on project funding by seeing if they have enough funds for a specific purpose; and
- improving comparison between charities.

There is a consensus amongst interviewees that restricted funds should refer to those funds that the donors have put specific restrictions on their use. Two interviewees express the view that the accounting for restricted funds will enable donors to see that their money has been applied as donated.

This finding supports Bird and Morgan-Jones (1981), who identify many different titles of funds used by charities: general fund, accumulated fund, capital fund, special fund, trust fund, restricted fund, defined purpose fund, earmarked fund, and endowment fund. Bird and Morgan-Jones (1981) also recommend a standard terminology for those different types of funds, and they generally categorise funds into unrestricted and restricted. They further classify restricted funds into:

- endowment funds;
- building and equipment funds; and
- restricted revenue funds.

In the UK, the recommendations by Bird and Morgan-Jones (1981) have been acted on by the publication of UK SORP 2005 Appendix 1, Paragraph 27 (Charity Commission, 2005) which defines a “fund” as:

A pool of resources, held and maintained separately from other pools because of the circumstances in which the resources were originally received or the way in which they have subsequently been treated. At the broadest level a fund will be one of two kinds: a restricted fund or an unrestricted fund.

SORP 2005 (Charity Commission, 2005) further categorises funds into unrestricted funds and restricted funds/special trusts. Unrestricted funds are funds that are expendable at full discretion of the trustees, whereas restricted funds are funds that are subject to limitation imposed by the donors (Charity Commission, 2005).

Treatment of fixed assets

Fixed assets either acquired by purchase or gift should be capitalised and depreciated appropriately over their useful life. The current practice of not capitalising and depreciating fixed assets in charities is considered unacceptable. This has been acted on in the United States where the American Institute of Certified Public Accountants (AICPA, 2006, Paragraph 9.05) in their NFP Organizations, have prescribed that the “contributions of property and equipment should be recognized at fair value.”

It is also interesting to note in the UK that before a prescribed method of accounting for fixed assets was required, 22 percent of charities expensed their fixed assets and 40 percent did not depreciate their fixed assets (Bird and Morgan-Jones, 1981). Since, the enactment of the SORPs (Charity Commission, 2005) there has been an almost 100 percent compliance on capitalizing and depreciating (Connolly and Hyndman, 2000). Hopefully similar findings will take place in New Zealand with the release and acceptance of NZICA’s (2006) *Not for Profit Financial Reporting Guide*.

Accounting basis

Donations should only be recognised as revenue when they are received or strongly committed, e.g. direct debit or automatic payment. This means a modified accrual basis may be appropriate for the treatment of donations. However, there may be a problem gaining acceptance of this practice among the charities, resulting in even more inconsistency and incomparability.

Fund-raising expenses

Some charities may allocate a significant portion of administration costs to fund-raising projects, whereas other charities may allocate part or none of the administration costs to fund-raising projects. One of the motivations of allocating administration costs to fund-raising projects may be trying to appeal to the donors for a lack of funds. It has to be admitted that comparability between charities should be improved by providing some guidance to charities as how to allocate the administration costs to fund-raising activities and ideally a consensus needs to be made on the appropriate percentage coverage that would be seen as a good benchmark for charities to achieve. This will ensure contributors know what portion of their donation goes to the beneficiary.

Conclusion

Our research has allowed us to draw several conclusions, which should contribute to a better understanding of the state of the financial accounts of charities in New Zealand. Part of the problem is to achieve some standardisation of terms and practices among charities. Specifically, we recommend firstly that funds be identified as either restricted or unrestricted. Second, all assets acquired be capitalised and depreciated. Third, charities should adopt a modified accrual accounting basis so that donations are only recognised when received as cash. Finally, some standardisation of overhead allocation should be established to apply to all revenues. To achieve this more in-depth interviews will need to take place.

In total, these measures will assist in achieving the primary goal of improving the transparency and understandability of the financial accounts of charities, bearing in mind that ASB (2005, p. 52) states "... it may not always be possible to present information in a way that can be understood by all users." Even auditors who consider that they have charity expertise failed to ensure that charities in the UK were complying with the appropriate charity reporting requirements (Palmer *et al.*, 2001). However, to achieve the goal of transparency we need to ensure that the majority of users understand what they are reading. While other improvements are possible, if the accounting treatments in the four areas identified above result in some standardisation and removal of ambiguities, worthwhile progress would have been made.

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