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# **Necessity of Audit Regulations on Charitable Organizations: Referring to the Scandal of Youth Challenge in Singapore**

*By*

**Fuminobu Mizutani**

## **Abstract**

JACO insists that strict audit regulations are not necessary for charitable organizations in the private sector. To consider whether such an assertion is really correct, this article examines the scandal of Youth Challenge in Singapore. Remuneration of more than S\$164,000 to the executive president was only disclosed in a note to audited financial statements, which was itself omitted from Annual Reports. Furthermore, there was unrecorded remuneration of more than S\$30,000. The external auditor expressed a non-qualified opinion on the financial statements. Audit regulations must be superior to those in place in Singapore prior to July 2006.

## **Key Words**

Charitable Organization, External Auditor, Audit Regulations, Youth Challenge, Singapore, Accounting Scandal, Non-Qualified Opinion, Remuneration, Chinese Language Realm, Not-for-Profit

## **1. Introduction**

Many Japanese insist that strict audit regulations are not necessary for charitable organizations in the private sector. However, in order to prevent scandals and help charitable organizations to continue their activities, there must be strict audit regulations. We can understand the necessity of audit regulations on charitable organizations by considering the scandal of Youth Challenge in Singapore.

Mr. Tatsuo Ohta's assertion must be influential in Japan. Many charitable organizations are members of the Japanese Association of Charitable Organizations (JACO), of which Mr. Ohta is presidential trustee. Mr. Ohta is erudite and his theory is reliable.<sup>1</sup> He advocates that any strict audit regulations are not necessary for charitable organizations in the private sector. Mr. Ohta comments upon the following.

- A law about the new corporation system of charitable organizations, which compels charitable organizations to be audited by independent auditors, was recently enacted in

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<sup>1</sup>Mr. Ohta has written many articles.

Japan. Each charitable organization can decide by itself the time when it will introduce the new corporation system. Concerning charitable organizations in the final year of applying the old corporation system, Mr. Ohta states, “I think such charitable organizations may not introduce an external audit.”<sup>2</sup> That is to say, Mr. Ohta thinks that it is not necessary for charitable organizations to be positively audited if explicit stipulations by the government do not exist.

- *Kanji* is a kind of corporate auditor in Japanese charitable organizations. Article 16 stipulates such auditors in an exposure draft of ministerial ordinance by the Ministry of Justice. About this article, Mr. Ohta criticizes: “The article requires that *Kanji* must communicate enough with trustees and staff at all times; however, *Kanji* must not become too friendly and must not lose his or her independence. Really, is there [a] necessity to stipulate about *Kanji* [so] strictly?”<sup>3</sup>
- Mr. Ohta criticizes regulations on “disclosure, and compulsion of internal control in large organizations” as “too heavy regulations.”<sup>4</sup>
- Mr. Ohta insists that there are cases in which “the government raises too detailed or improper instructions and requires explanation through additional materials or other ways on charitable organizations” in Japan. Mr. Ohta continues, “Such examination style ... (omission) ... sometimes makes...charitable activities worse.”<sup>5</sup>
- Mr. Ohta even criticizes the plan that forces charitable organizations to have “accounting skills and other management skills.” Mr. Ohta states that “the government should abolish its control system on charitable organizations... and should leave management styles of charitable organizations [to] self-governance.”<sup>6</sup>

Mr. Masao Katayama, trustee of JACO and executive trustee of the Saison Foundation, insists that because fundraising is more difficult in Japan than in the U.S. and Japanese charitable organizations cannot pay excessive remuneration to managers, regulations are not needed to prevent excessive remuneration in Japan.<sup>7</sup>

However, when considering the practice of charitable organization management, the assertion of JACO is questionable. Although Mr. Ohta has interests in not-for-profit organizations in the U.K. and in the People's Republic of China (P.R.C.), both of which have more detailed regulations on various aspects for not-for-profit organizations than Japan,<sup>8</sup> Mr. Ohta considers Japanese regulations to be too detailed and stringent. However, it is not impossible to guess that accounting scandals occur when regulations are scarce or absent. Mr. Ohta puts value on “continuous charitable activities.”<sup>9</sup> If there is an accounting scandal in a country that has few regulations, and such scandal prevents continuous charitable activities and is related to excessive remuneration, the theory of JACO would be incorrect.

<sup>2</sup>JACO (2009-2010). Mr. Ohta responded to an anonymous query about large charitable organizations under the old corporation system.

<sup>3</sup>Ohta (2007).

<sup>4</sup>Ohta (2008), p.26.

<sup>5</sup>Ohta (2009).

<sup>6</sup>Ohta (2007).

<sup>7</sup>Katayama (2010).

<sup>8</sup>Ohta (2005) and Ohta (2004).

<sup>9</sup>Ohta (2008), p.28.

## 2. Selecting a Case

We should select a famous foreign case with qualitative conditions as a reference.

We must not select as a reference not-for-profit organizations in countries whose governments intervene. We should select a scandal in Singapore, which has a laissez-faire culture, and one dated before July 1, 2006,<sup>10</sup> when Singapore had almost “no regulations”<sup>11</sup> on not-for-profit organizations except for accounting standards themselves. Donations in Singapore occupy smaller GDP percentages than they do in the U.S or the U.K. If there are remuneration scandals in Singapore, Mr. Katayama’s opinion is also incorrect.

In fact, many not-for-profit organizations in Singapore have recently been the victims of scandal. Youth Challenge, which is qualitatively like a Japanese charitable organization, had revenue of more than S\$442,000 in the fiscal year of 2005.<sup>12</sup> Its accounting scandal had a great impact in the Chinese language realm. Mass media, which broadcast this scandal, included *Zaobao*, a Chinese newspaper in Singapore, and some mass media in the P.R.C.<sup>13</sup> The scandal was also broadcast in Taiwan.<sup>14</sup> Youth Challenge received sympathy from movie stars in Hong Kong.<sup>15</sup> Youth Challenge and its scandal are not well-known to the Japanese, but the organization is a familiar name to the Chinese.

Youth Challenge was established in 1985 for regeneration support of “Centrepont Kids,” or juvenile delinquents.<sup>16</sup> In 2006, when the government began investigation into the scandal of Youth Challenge, the group was known as a dispatcher of volunteers abroad.<sup>17</sup>

## 3. Scandal of Youth Challenge

One of the secondary objectives of auditing is to prevent errors and fraud by the deterrent and moral effect of auditing;<sup>18</sup> however, the scandal of Youth Challenge pertained to auditing. The Commissioner of Charities (COC; A Division of Inland Revenue Authority of Singapore before August 2006, and of the Youth and Sports Agency of the Ministry of Community after September 2006) indicated on August 21, 2006 that the financial activity of Youth Challenge was suspicious.<sup>19</sup> Deloitte, one of the Big 4,<sup>20</sup> worked as the investigating auditor for the COC.<sup>21</sup>

The COC published its report<sup>22</sup> on January 23, 2007, and indicated that Youth Challenge had problems in three areas: corporate governance, internal control, and transparency. The Institute of Certified Public Accountants of Singapore (ICPAS) approved the report by the COC only two days after its publication.<sup>23</sup> Thus we consider problems related to accounting

<sup>10</sup> *Straits Times* (Aug. 22, 2006).

<sup>11</sup> *Straits Times* (Aug. 21, 2006).

<sup>12</sup> COC (2007b), p.3. “S\$” means “Singapore dollar.”

<sup>13</sup> *Brand China Online* (Nov. 8, 2007).

<sup>14</sup> *Central News Agency* (Jan. 24, 2007).

<sup>15</sup> *Straits Times* (Aug. 22, 2006).

<sup>16</sup> *Straits Times* (Aug. 23, 2006).

<sup>17</sup> *Straits Times* (Mar. 17, 2010).

<sup>18</sup> Millichamp and Taylor (2008), p.4.

<sup>19</sup> IRAS (2006).

<sup>20</sup> The four largest accounting offices in the world.

<sup>21</sup> COC (2007b) and *Channel NewsAsia* (Feb. 13, 2007).

<sup>22</sup> COC (2007b). Most of this section is based on this report, except for the portions with particular footnotes.

<sup>23</sup> *Channel NewsAsia* (Jan. 25, 2007).

procedures and auditing based on the indications by the COC.

Remuneration of more than S\$164,000 paid to Mr. Vincent Lam, the executive president, was disclosed in the audited financial statements, but only in a note. That note was omitted from Annual Reports<sup>24</sup> disclosed to the public. Furthermore, there was unrecorded remuneration of more than S\$30,000. In other words, remuneration of more than S\$194,000 was not properly disclosed.<sup>25</sup>

Mr. Katayama's opinion is contradicted by the existence of excessive remuneration in Singapore, where donations do not occupy large GDP percentages.

Although the COC did not announce names, the external auditor of Youth Challenge was Ernst & Young, which expressed a non-qualified opinion. Mr. Lam disputed the COC based on this non-qualified opinion.<sup>26</sup> Soon after the COC decided to investigate, Mr. Lam insisted that there were no problems in Youth Challenge;<sup>27</sup> even after the investigation, Mr. Lam maintained this assertion and criticized Deloitte.<sup>28</sup>

The internal auditor of Youth Challenge was an executive trustee of the Singapore Environment Council, a private not-for-profit organization.

The not-for-profit accounting standards in Singapore were Recommended Accounting Practices 6 (RAP 6) stipulated by the Council of the Singapore Society of Accountants (which was the ancestor of ICPAS) in 1987 and revised by ICPAS in 2005.<sup>29</sup> We can regard RAP 6 as a guide for auditors, although RAP 6 was not mandatory.<sup>30</sup>

Annual Reports of Youth Challenge seemed to violate RAP 6. RAP 6 had been requiring not-for-profit organizations to disclose administrative expenses since it was stipulated in 1987.<sup>31</sup> RAP 6 even required not-for-profit organizations to explain the accounting policies of administrative expenses.<sup>32</sup> RAP 6 wanted the explanations of accounting policies to be clear and fair.<sup>33</sup>

Because Youth Challenge recognized that it had lost its credibility and ability to support youth, the group halted its activities in March 2010.<sup>34</sup> The scandal, under almost no regulations, destroyed the continuous charitable activities of Youth Challenge.

As mentioned above, the COC also indicated problems not only in the transparency of Youth Challenge, but also in its corporate governance and internal control. However, the consideration about the corporate governance and the internal control makes the scope of this article too wide. Thus, this article does not consider the corporate governance and the internal control of Youth Challenge.

<sup>24</sup>Somehow, neither the National Library of Singapore nor the NUS Libraries possess Annual Reports of Youth Challenge published when this scandal occurred. NUS is the acronym of the National University of Singapore.

<sup>25</sup>Mr. Lam's total annual remuneration from Youth Challenge was more than S\$248,000. (The remuneration of S\$194,000 which was not properly disclosed was included in this amount.)

There are no accessible materials about the reason why Youth Challenge did not perfectly hide the remuneration of S\$164,000.

<sup>26</sup>*Straits Times* (Aug. 23, 2006).

<sup>27</sup>*Straits Times* (Aug. 22, 2006).

<sup>28</sup>*Channel NewsAsia* (Feb. 13, 2007).

At almost the same time of the investigation, the chairman of the COC was the chairman of Ernst & Young Singapore branch (COC (2007a), p.8). This says that there was a human relationship between the COC and Ernst & Young.

<sup>29</sup>Council of the Singapore Society of Accountants (1987) and ICPAS (2005).

National University of Singapore Central Library kindly lent me the first edition of RAP 6.

<sup>30</sup>Council of the Singapore Society of Accountants (1987), Foreword.

<sup>31</sup>Council of the Singapore Society of Accountants (1987), par.26 (b).

<sup>32</sup>Council of the Singapore Society of Accountants (1987), par.36 (a).

<sup>33</sup>Council of the Singapore Society of Accountants (1987), par.35.

<sup>34</sup>*Straits Times* (Mar. 17, 2010).

## 4. Problems on this Case

The important problems were lack of auditing regulations, with the exception of accounting standards, and lack of intervention by the government, although the starting point of this scandal was misleading reporting by the executive president. Strict audit regulations can prevent such misleading reporting and even excessive remuneration itself. Mr. Zhiming Zhang at Dongbei University of Finance and Economics in the P.R.C. is conducting an ongoing study about the scandal of Youth Challenge. Mr. Zhang advocates strict regulations as countermeasures.<sup>35</sup>

Audit regulations consist of auditing standards, some aspects of accounting standards, and others. Because there were somewhat sophisticated not-for-profit accounting standards in Singapore, the main problems with regulations must not involve accounting standards. About commercial accounting, Prof. Robert W. Holthausen at the University of Pennsylvania indicates that Singapore has weak enforcement except for some aspects, while Singapore has sophisticated accounting standards.<sup>36</sup> Prof. Holthausen insists that enforcement by both the public and private sectors is important to make businesses compliant with accounting standards.<sup>37</sup> Strength of enforcement probably depends on auditing standards, intervention by the government, and other factors.

Ernst & Young expresses a non-qualified opinion. Ernst & Young is large and has bargaining power, as well as access to RAP 6, which can help auditors in Singapore. If there were strict audit regulations, Ernst & Young would express a qualified opinion for the reasons that did not properly disclose remuneration and were far different from RAP 6.

The internal auditor, who was also executive trustee of another not-for-profit organization, did not economically rely on Youth Challenge. If there were strict audit regulations, the internal auditor could have criticized the financial statements of Youth Challenge.

The auditors of Youth Challenge might ignore RAP 6. ICPAS has been recommending but not mandating that charities apply RAP 6.<sup>38</sup> The external auditor of Youth Challenge had to know RAP 6 because the external auditor was a member of ICPAS. The internal auditor of Youth Challenge probably knew RAP 6, considering the prestige of ICPAS.<sup>39</sup>

In addition, if the government of Singapore often examined charitable organizations, large scandals could be prevented. The government of Singapore relied too heavily on markets and neglected necessary intervention. There seems to be rationalization regarding intervention, including audit regulations, by the government in Japan.

## 5. Conclusion

In order to continue charitable activities in Japan and other countries, audit regulations must increase and be strengthened.

Mr. Ohta's assertion is that strict audit regulations are not necessary for charitable

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<sup>35</sup>Zhang (2008).

<sup>36</sup>Holthausen (2009), pp.449–450.

<sup>37</sup>Holthausen (2009), especially pp.456–457.

<sup>38</sup>Council of the Singapore Society of Accountants (1987), Foreword.

<sup>39</sup>By the way, RAP 6 also mentioned auditing. RAP 6 required not-for-profit organizations to attach an auditor's report to the annual report if the financial statements have been audited (Council of the Singapore Society of Accountants (1987), par.22 (c)).

organizations in the private sector. However, Mr. Ohta's assertion must be incorrect, given the 2006 scandal of Youth Challenge in Singapore, which was subject to few regulations other than accounting standards themselves. Although the financial reporting by Youth Challenge was far different from RAP 6, the external auditor expressed a non-qualified opinion.

The necessity of precautions against misleading reporting about remuneration seems to be a peculiarity of not-for-profit organization auditing. Excessive remuneration beckons misleading reporting. Mr. Katayama states that there is little necessity for regulations to prevent excessive remuneration because Japanese not-for-profit organizations are not wealthy. However, Mr. Katayama's opinion must also be incorrect given the remuneration scandal in Singapore, where donations occupy small GDP percentages. Strict auditing promotes the transparency of not-for-profit organizations and may prevent excessive remuneration.

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