
REVIEW OF THE FINANCIAL REPORTING ACT 1993 PART I: THE FINANCIAL REPORTING STRUCTURE

Discussion Document

March 2004

ISBN 0-478-26360-0

© Crown Copyright
First Published March 2004
Regulatory and Competition Policy Branch
Ministry of Economic Development
PO Box 1473
Wellington
New Zealand
<http://www.med.govt.nz>

Permission to reproduce: The copyright owner authorises reproduction of this work, in whole or in part, so long as no charge is made for the supply of copies, and the integrity and attribution of the work as a publication of the Ministry of Economic Development is not interfered with in any way.

TABLE OF CONTENTS

TABLE OF CONTENTS	iii
SUMMARY OF QUESTIONS FOR SUBMISSION	iv
REVIEW OF THE FINANCIAL REPORTING ACT.....	vi
EXECUTIVE SUMMARY	vii
TABLE OF ABBREVIATIONS	viii
INTRODUCTION.....	1
UNDERLYING PRINCIPLES OF FINANCIAL REPORTING REQUIREMENTS	6
BACKGROUND: ACCOUNTING STANDARDS.....	8
REPORTING ENTITIES.....	13
AUDITING AND FILING REQUIREMENTS	27
ENTITY NEUTRALITY.....	34
SECTOR NEUTRALITY	36

SUMMARY OF QUESTIONS FOR SUBMISSION

Question 1 – Reporting Entities

- a. Do you agree that it is appropriate to have different reporting requirements for different types and sizes of entities in New Zealand? If not, what reporting requirements should there be and why?
- b. If you believe that there should be different reporting requirements for different types and sizes of entity, do you agree with the ASRB proposal on how the different types and sizes of entity should be determined? Are there any additional factors or considerations that you believe are appropriate to consider in determining the tier of a given entity?
- c. Do you agree that the ASRB's proposed two-out-of-three combination of assets, turnover and employees is appropriate? Do you agree that the figures used are appropriate?
- d. Do you agree with the removal of reporting requirements for tier 3 entities under the ASRB proposal? If not, what reporting requirements should there be and why?
- e. Do you believe that optional compliance with a "best practice" guide would prove beneficial? If so, do you agree that meeting the best practice guide should mean automatic compliance with the general reporting requirements (for example, of the Companies Act 1993) through a deeming provision?
- f. Do you agree that the current tier 2 categorisation of large entities without reporting responsibilities, and small entities with reporting responsibilities, is appropriate?
- g. If the ASRB proposal was adopted, are you aware of significant reporting issues that may arise for any entities?
- h. If, instead of the ASRB proposal, a two-tier structure like that operating in Australia was adopted, are you aware of significant reporting issues that may arise for any entities?

Question 2 – Auditing and Filing Requirements

- a. Should audit and filing requirements correspond directly with tiers of reporting entity? If not, what alternatives would be appropriate? A mechanism to allow audit and filing requirements to shift independently of reporting requirements, or some other approach?
- b. Which entities (either of tiers 1, 2 and 3, or some other measure) should be required to have their financial statements audited and why?
- c. Which entities (either of tiers 1, 2 and 3, or some other measure) should be required to file their financial statements and why?
- d. If you do not believe all entities should be required to file financial statements, do you believe some value would be gained from some form of alternative (whether those provided or otherwise) for those that do not file their reports?

- e. Are there any further issues (for example, in relation to trans-Tasman co-ordination or a possible joint institution) that need to be considered?

Question 3 – Entity Neutrality

- a. Do you agree that some form of entity neutrality is desirable?
- b. If not, what reporting requirements do you believe entities not currently subject to the Financial Reporting Act 1993 should be required to fulfil?
- c. If you do agree that entity neutrality is desirable, are there nevertheless some forms of entity that should be exempt from the reporting requirements?
- d. Are there any further issues (for example, in relation to trans-Tasman co-ordination or a possible joint institution) that need to be considered?

Question 4 – Sector Neutrality

- a. Do you agree with the approach to sector neutrality being adopted by the ASRB?
- b. Are there implications for the institutional arrangements regarding standard setting for the New Zealand public sector? If so, what are they and how should they be addressed?
- c. Are there any further issues (for example, in relation to trans-Tasman co-ordination or a possible joint institution) that need to be considered?

REVIEW OF THE FINANCIAL REPORTING ACT

PROCESS

The Ministry of Economic Development has prepared this discussion document following consultation with other government officials and agencies. Written submissions on the issues raised in this document are invited from all interested parties. The closing date for submissions is **Friday, 14 May 2004**. After receipt of submissions, the Ministry will evaluate them and seek further comments where necessary before developing recommendations for the government to consider.

Submissions should be sent either by e-mail (in Microsoft Word 2000 format or compatible) to matthew.farrington@med.govt.nz, or in hard copy to:

Review of the Financial Reporting Act 1993
Ministry of Economic Development
PO Box 1473
WELLINGTON
Attention: Matthew Farrington
Regulatory and Competition Policy Branch

Any queries should be directed to Matthew Farrington, either at the above e-mail address, or by telephone at (04) 470 2313, or by facsimile at (04) 471 2658.

OFFICIAL INFORMATION ACT 1982 AND PRIVACY ACT 1993 REQUIREMENTS

Please note that the contents of submissions provided to the Ministry of Economic Development in response to this discussion document will be subject to both the Official Information Act 1982 and the Privacy Act 1993. If the Ministry receives a request for information contained in a submission, it would be required to consider release of the submission, in whole or in part, in terms of the criteria set out in these Acts.

In providing your submission, please advise if you have any objections to the release of any information contained in your submission, and, if you do object, the parts of your submission you would wish withheld, and the grounds for withholding.

DISCLAIMER

Any statements made or views expressed in this discussion document are the views of the Ministry of Economic Development and do not reflect government policy.

Readers are advised to seek specific advice from a professional qualified in the relevant subject area before undertaking any action in reliance on the contents of this discussion document. While every effort has been taken to ensure that the information contained in this document is accurate, the Crown does not accept any responsibility whether in contract, tort, equity or otherwise for any action taken, or reliance placed on any part, or all of the information in this document, or for any error or omission from this document.

EXECUTIVE SUMMARY

This discussion document forms a part of the Ministry of Economic Development's fundamental review of the Financial Reporting Act 1993 and deals specifically with the question of "who is required to report?"

The discussion document briefly canvasses the reasons for this review, in particular the move towards International Financial Reporting Standards. As part of the background and as an aid to developing the issues covered by this document, a brief outline of the rationales behind imposing financial reporting standards and the use of financial reports is provided.

The discussion of the financial reporting framework is split into four main areas. First, there is a discussion of reporting entities. This considers which entities should be required to comply with the financial reporting requirements, and possible exemptions or relief from the full requirements where imposing such requirements are not justified. An outline of comparative international jurisdictions is provided. As a basis for discussion, the proposal made by the Accounting Standards Review Board is provided. This proposal would result in a three-tier reporting framework, with a top tier of issuers, certain Crown agencies and departments, and large entities with "reporting responsibilities." Smaller entities with reporting responsibilities, large entities without reporting responsibilities, and certain other entities would form the second tier, with reduced reporting requirements, while the smallest entities would fall in the third tier and be largely without formal reporting responsibilities.

Secondly, the discussion document canvasses the requirements for audit and filing of financial reports on a similar basis to reporting requirements, with an outline of comparative international jurisdictions and a cost-benefit analysis.

Thirdly, the discussion document considers entity neutrality and the possibility of having one set of financial reporting standards with universal application to all types of entity.

Finally, the discussion document considers sector neutrality and the applicability of financial reporting standards outside the profit-seeking corporate sphere to governmental agencies and other "public benefit" entities. This includes a summary of New Zealand's current position and possible alternatives for moving forward.

As a point of general application, this document reflects New Zealand's particularly close economic relationship with Australia and the desire to reduce trans-Tasman impediments to business. This is especially applicable in the context of a discussion related to international standards, where the overarching desire is to promote international comparability generally.

TABLE OF ABBREVIATIONS

The following abbreviations have been used in the discussion document and are provided here for reference:

ASIC	Australian Securities and Investments Commission – Australia's company, financial services and securities regulator; Website: http://www.asic.gov.au
ASRB	Accounting Standards Review Board – the New Zealand accounting standards setter, established under the Financial Reporting Act 1993; Website: http://www.asrb.co.nz
FASB	Financial Accounting Standards Board – the United States accounting standards setter; Website: http://www.fasb.org
GAAP	Generally Accepted Accounting Practice. Defined in the Financial Reporting Act 1993, the Public Finance Act 1989 and Local Government Act 2002. The concept includes applicable financial reporting standards and accounting policies that have "authoritative support" within the accounting profession in New Zealand and are appropriate to the circumstances of the individual entity;
GFS	Government Finance Statistics – IMF system for statistical analysis of government finances;
IASB	International Accounting Standards Board – international body that produces IFRS; Website: http://www.iasb.org
ICANZ	Institute of Chartered Accountants of New Zealand – professional accountancy body with several functions, in particular, the dominant provider of technical expertise for standards; Website: http://www.icanz.co.nz
IFAC	International Federation of Accountants – international professional body of accountants; Website: http://www.ifac.org
IFAC-PSC	International Federation of Accountants Public Sector Committee – IFAC committee that produces IPSAS; Website: http://www.ifac.org/publicsector/
IFRS	International Financial Reporting Standards – international standards for financial reporting of profit-oriented entities, produced by the IASB;

IMF	International Monetary Fund – international organisation for promoting international monetary co-operation and stability, produces GFS;
IPSAS	International Public Sector Accounting Standards – financial reporting standards for public sector entities, set by IFAC-PSC;

INTRODUCTION

1 The Financial Reporting Act was enacted in 1993 as part of a wider package of company law reform. The Act places an obligation on certain entities to prepare financial statements¹ and provide those statements to the Registrar of Companies.² It further establishes a body, the Accounting Standards Review Board ("ASRB"),³ which is charged with prescribing the requirements for financial reporting by those entities,⁴ and giving these requirements the force of law.⁵

2 The Ministry of Economic Development, in consultation with various stakeholders, has determined that the requirements of the Act should be reviewed. There are several reasons for this, particularly the global trend towards international accounting standards⁶ and perceived deficiencies in several aspects of the regime.

3 Following this review, it is intended that New Zealand's financial reporting regime will be sufficiently flexible to take into account international standards and developments, while not compromising the positive aspects of New Zealand's current reporting landscape. The review will also address issues of general significance, and in particular is aimed at minimising compliance costs.

SCOPE OF THE REVIEW

4 The review will consider all aspects of the Financial Reporting Act and financial reporting in New Zealand. However, the review is split into two parts. This is primarily due to the current proposal for some form of enhanced trans-Tasman co-operation, which may take the form of a joint institution.

5 This issue was discussed by Senator the Hon Helen Coonan, the Australian Minister for Revenue and Assistant Treasurer, and Hon Lianne Dalziel, then the New Zealand Minister of Commerce, at the 20th Anniversary Closer Economics Relations meeting in Sydney in August 2003. They issued a joint press release⁷ that highlighted Australia and New Zealand's joint commitment, reinforced by global trends, to reducing business costs through the development of an efficient and effective process for trans-Tasman standardisation of accounting standards.

6 This was confirmed by Hon Peter Costello, Australian Treasurer and Hon Dr Michael Cullen, New Zealand Minister of Finance at recent talks, where they jointly announced the establishment of an accounting standards advisory group, which will look at ways of reducing costs and improving efficiency through a single set of standards.⁸

7 As many of the substantive issues, in particular institutional issues, cannot be discussed properly without also taking into account the trans-Tasman dimension, the Ministry of Economic Development decided that these substantive issues should be

¹ Financial Reporting Act 1993, section 10

² *ibid.*, section 18

³ *ibid.*, section 22; see generally <http://www.asrb.co.nz>

⁴ *ibid.*, section 25

⁵ *ibid.*, section 27

⁶ See paragraphs 31 and following, *infra*

⁷ Available at

http://www.dfat.gov.au/geo/new_zealand/anz_cer_20years/joint_statement_nz_treasurer.html and

<http://www.mft.govt.nz/foreign/regions/australia/cer2003/cerbusinesslawstatement.html>

⁸ Available at <http://www.treasurer.gov.au/tsr/content/pressreleases/2004/006.asp>

held over until any proposals for co-ordination are better advanced. It is therefore proposed to release a second discussion document on the substantive issues (probably concurrently with a trans-Tasman co-ordination document).

8 In considering the issues raised in this discussion document, submitters are therefore asked to consider this possibility, as well as a general desire for trans-Tasman co-ordination.

Part I – The Financial Reporting Structure

9 Part I primarily considers the financial reporting structure in New Zealand – that is, answering the issue of "who is required to report?" This includes a discussion of the ASRB proposal for a financial reporting structure, auditing and filing requirements, entity neutrality and sector neutrality.

Financial Reporting Structure

10 New Zealand has a statutory two-tier system for financial reporting, with a further non-statutory intermediate tier implemented by ICANZ and approved by the ASRB. This framework is intended to encourage timely disclosure of reliable information, while ensuring that users' information needs are met with minimum cost to the provider. The top tier consists of "reporting entities," which must prepare full financial statements in accordance with all applicable financial reporting standards, and includes entities such as public issuers, larger companies, government departments, Crown entities and local authorities. Some of these entities are also required to have their financial statements audited and to file them with the Registrar of Companies. The bottom tier of "exempt companies" (small companies that fall below certain asset and income thresholds) must still prepare financial statements, but the requirements are outdated. The intermediate tier requires reports from certain entities (mainly medium-sized or closely held companies) that are less onerous than the full requirements. However, this intermediate tier operates by virtue of exemptions granted within the standards approved by the ASRB, rather than directly through the Financial Reporting Act.

11 Although it is generally accepted that it is not desirable to subject smaller entities to the full requirements of financial reporting, the appropriateness of this particular system needs to be considered. The ASRB has proposed a new fully-statutory three-tier regime that aims to more appropriately impose reporting requirements proportionate to the potential economic impact of the entity.

Audit and Filing

12 Closely related to reporting requirements are obligations to have reports audited and filed. This review addresses the costs and benefits of doing so, as well as examining possible alternatives to minimise costs.

Entity Neutrality

13 New Zealand does not have a uniform financial reporting regime that encompasses all forms of entity. The Financial Reporting Act imposes reporting requirements on companies, issuers and a variety of public entities, including State Owned Enterprises, Crown entities, local authorities and government departments. However, there are some gaps in reporting requirements, particularly for entities such as partnerships, charities, trusts and so on. The discussion document therefore explores the possibility of achieving greater consistency of reporting requirements across the range of forms of entity.

Sector Neutrality

14 Current New Zealand standards are "sector neutral," that is, the same standards apply to all sectors regardless of whether there is a profit motive or not. They therefore apply to "public benefit entities," entities whose primary objective is not to provide financial returns on equity, but rather perform some sort of social benefit, and whose capital has been provided in order to facilitate that objective. This primarily incorporates the public sector, including most organs of government, but also charities and other similar organisations.

15 Sector neutrality has several benefits, including producing generally superior reports and increasing the comparability and familiarity of reports across sectors, thereby promoting transparency. However, current international standards are designed only for profit-seeking corporates. There is, therefore, concern in New Zealand that reporting standards remain relevant for the public and not-for-profit sectors.

Part II – Other Issues

16 Part II will consider all other issues, and is intended to be released in mid-2004. It will specifically include the following major issues:

Application of International Financial Reporting Standards

17 The Financial Reporting Act is predicated on the assumption that New Zealand is a "standards setter," creating its own financial reporting standards, rather than a "standards taker," accepting standards created elsewhere. However, following the introduction of international standards,⁹ it is questionable whether this is an appropriate model. In this context, issues such as the allowable scope for derogations and modifications to international standards will also be considered, as well as any threshold test for adoption or otherwise.

Institutional Arrangements

18 Part II will also consider the functions of the institutional bodies associated with financial reporting standards. This will take into account any outcomes from the trans-Tasman advisory group, as well as consider the appropriate functions, powers and operational arrangements of current institutional bodies. A particular issue in this regard is considering the inclusiveness of process. Other countries, including Australia and the United Kingdom, have arrangements whereby a wider selection of stakeholders other than accountants, including representatives from a cross-section

⁹ See paragraphs 37 and following, *infra*

of the market and other interests, have a meaningful role in financial reporting institutions. This may need to be considered in New Zealand.

Enforcement

19 The Financial Reporting Act states that New Zealand accounting standards have the force of law and sets out criminal penalties for failure to comply. Two broad enforcement issues need to be considered.

20 The first is whether the existing criminal penalty provisions effectively deter misreporting. There are some civil offence provisions in other areas of business law, such as securities and competition law. It would be useful to explore whether this approach, and any other forms of remedy, might be appropriate for the Financial Reporting Act regime. The second is whether it may be appropriate to consider the appropriate enforcement roles (if any) for institutions. Effective enforcement and deterrence mechanisms, along with high quality reporting standards and good standards of corporate governance practice, are the key elements necessary for any financial reporting infrastructure to be effective in achieving the objective of delivering high quality financial reporting.

Auditing Standards

21 Auditors play a crucial role in ensuring that financial statements can be relied upon by users. However, auditing standards are a high-profile issue in light of recent events in Australia, the United States and Europe, in particular, where the actions of auditors have been questioned. At present, ICANZ is responsible for both regulating auditors and setting audit standards. Given current international trends and the critical role that auditors have in the enforcement process, it is desirable to consider whether some degree of independent oversight might be required.

Overseas Companies

22 The Financial Reporting Act and sections of the Companies Act 1993 create a special reporting regime for overseas-incorporated and overseas-owned companies. This includes requirements that overseas companies file separate audited financial statements for both their New Zealand business and their global business and must prepare full financial statements if their home country obligations are not "substantially the same" as those under the Financial Reporting Act. In response to the Ministerial Panel on Business Compliance Costs' findings¹⁰ on the overseas companies regime, it is appropriate to consider the compliance costs imposed and whether they are justified in all circumstances.

Other Issues

23 At this stage, it is also intended to consider several other issues that will ensure the Act operates in an effective manner. This may include issues related to technical neutrality and methods of filing, in particular, the use of XBRL,¹¹ as well as the time for filing and the potential for "concise" financial reports.¹²

¹⁰ *Finding the Balance: Maximising Compliance at Minimum Cost*, Ministerial Panel on Business Compliance Costs, July 2001, available at <http://www.businesscompliance.govt.nz/reports/final/index.html>

¹¹ See <http://www.xbrl.org>, <http://www.xbrl.org.nz> and http://www.icanz.co.nz/StaticContent/services/xbrl_factsheet.cfm

¹² See, for example, Corporations Act 2001, section 314 (Aus)

PROCESS AND TIMEFRAME FOR THE REVIEW

24 Submissions will close on **14 May 2004**, and the Ministry of Economic Development expects to make recommendations to the Minister of Commerce by 31 July 2004. Announcements can be expected to be made around August 2004. Legislation is expected to be enacted by the end of 2005. Until that point, the current requirements for financial reporting as set out in the Financial Reporting Act and associated standards remain in force.

25 Part II of the review is expected to commence in the near future. However, exact timing for Part II is not yet available, as this is dependent on the trans-Tasman accounting advisory group. At time of publication, the advisory group was yet to meet.

UNDERLYING PRINCIPLES OF FINANCIAL REPORTING REQUIREMENTS

26 General purpose financial reports are, in the words of the Institute of Chartered Accountants of New Zealand ("ICANZ"),¹³ "intended to provide information to meet the needs of external users who are unable to require, or contract for, the preparation of special reports to meet their specific information needs."¹⁴

27 These information needs arise for a variety of reasons. It is therefore important to appreciate the underlying rationales behind reporting requirements before considering changing them. Generally, any requirements should advance one or more of the rationales, and keeping these underlying rationales in mind when considering options to resolve any given issue aids the decision making process.

28 The Ministry of Economic Development has identified the following non-exhaustive and inter-related list of rationales that have been used in developing the issues in this discussion document:

- *Accountability*: The primary reason for imposing external financial reporting requirements is to correct "information asymmetries,"¹⁵ ensuring that external users of reports are able to access the information necessary for their purposes. In particular, these reports can be used by the owners, shareholders or stakeholders of an entity (or those acting on their behalf) to assess the performance of the entity's management and hold the managers to account where needed;
- *Transparency*: In addition to holding management accountable to the owners, shareholders or stakeholders of an entity, financial reports also enable other external parties to assess the continued viability of the entity. This may include debtors and creditors of an entity that are unable to demand special purpose reports (for example, trade creditors) as well as persons considering investments in, mergers with, or takeovers of, a given entity. There are also other parties that may have a legitimate interest in the performance of a given entity, such as prospective and existing employees;
- *Monitoring*: Financial reports indicate various aspects of an entity's performance. This information is commonly used by academics and analysts to determine such things as business sustainability. The information can also be used to gauge more general matters, such as general economic outlooks. Finally, financial reports are used by various agencies to monitor the activities and compliance of reporting entities;
- *Enforcement*: Financial reports may be used to enforce other areas of substantive law. For example, the Securities Commission may use financial reports as evidence of the quality and extent of disclosures that are made by issuers to the market in prospectuses for securities offerings, or in their periodic financial reporting. Financial reports may also be used by private individuals in a variety of legal actions; and

¹³ See generally <http://www.icanz.co.nz>

¹⁴ *Statement of Concepts for General Purpose Financial Reporting*, Institute of Chartered Accountants of New Zealand, 1993, paragraph 1.5

¹⁵ For information asymmetries, see in general "The Legal and Institutional Preconditions for Strong Securities Markets" 48 *UCLA Law Review* 781 (2002), by Professor Bernard S. Black, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=182169

- *Internal governance:* Although general purpose financial reporting requirements are primarily imposed for the benefit of external users, such requirements can also promote good internal financial discipline. Prudent financial management is likely to be beneficial to the entity itself, and thereby, its stakeholders.

29 A further issue to consider is the costs involved in imposing these reporting requirements. The government is committed to ensuring that costs to business are only imposed where they can be justified and there is a net benefit. These costs can take many forms, but in particular (from a business perspective) are the direct costs of regulatory requirements and the compliance costs associated with complying with those regulatory requirements. Also relevant are the costs to the economy generally, where imposing or altering regulatory requirements has some potentially wider side effects, such as reduced incentives for international investment or the misallocation of resources.

30 This discussion document has made an effort to identify potential areas of cost, but it would be helpful if submissions making references to cost issues, both direct costs and compliance costs, were able to provide quantitative or qualitative estimates to support their points of view.

BACKGROUND: ACCOUNTING STANDARDS

31 Although general purpose financial reports are intended to provide financial information for external users, the value of such reports can be undermined. At the extreme, information can be disguised so as to obscure the actual position and performance of the entity preparing the report. However, even without persons behaving in a less than forthright manner, the value of general purpose reports can be limited if the external users relying on them cannot readily comprehend the information. In particular, if an entity creates its financial reports using unique accounting practices and methods, the value of information presented is significantly undermined. The financial report could not be properly understood without first understanding that entity's unique accounting practices.

32 Accounting standards therefore provide a general framework to communicate financial information so that the financial performance and position of an entity can be meaningfully assessed. Although accounting standards do not require identical reports from all entities, persons with knowledge of the basic framework and degree of discretion available to a given entity are able to readily discern the information relevant to them. This information enables investors, creditors, analysts, regulatory authorities and the entities themselves to make informed decisions about the allocation of resources.

33 The significantly improved comprehensibility of reports produced in accordance with accounting standards promotes investor confidence and market integrity. Investors, shareholders, regulators and other stakeholders can more accurately assess the position of entities, enhancing the integrity of the market. Where a market is seen to operate with integrity, investor confidence generally improves. Investors can also make investments in individual entities with confidence in that entity. This general and individual confidence leads to a reduction in the cost of capital throughout the economy. Public confidence in the integrity of the financial reporting framework is therefore central to maintaining and expanding a sophisticated domestic capital market.

34 In relation to the not-for-profit sector, accounting standards also enhance accountability, enabling stakeholders to more readily track public monies and ensure they are put to their proper purpose. In the public sector, accounting standards provide a framework for parliamentary scrutiny of the government's management of the Crown's assets and liabilities. For public benefit entities, confidence is analogous to the private market – where the public has confidence that their contributions are being used appropriately, future fundraising activities are more likely to succeed.

35 However, in today's increasing global economy where capital flows across borders, domestic conformity is inadequate. An international investor wishing to invest must, before studying the financial reports of a given entity, understand the reporting framework of the country in which that entity is based. In line with the reasons for imposing domestic conformity, there have therefore been moves to introduce international conformity through the use of identical standards.

36 The concept of an internationally accepted single set of financial reporting standards is not new. Markets have long recognised the need for reliable and transparent accounting and financial reporting to enable decisions by those providing capital. The various stockmarket crashes of the 1980s and the 1998 Asian economic crisis renewed these calls for a commitment to a single set of financial reporting standards, a call that has been reinforced by recent corporate collapses and scandals. Various bodies and individuals have also identified financial reporting as

one aspect of corporate performance where there is scope to improve the accountability of participants.

THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

37 The International Accounting Standards Board ("IASB")¹⁶ is an independent, privately funded accounting standard setter based in London. The IASB is committed to developing, in the public interest, a single set of high quality, understandable, global accounting standards for profit-seeking corporates that require transparent and comparable information in general purpose financial statements. In addition, the IASB co-operates with national accounting standard setters, including those in New Zealand, to achieve convergence in accounting standards around the world.

38 For those countries that do not currently have high-quality accounting standards, the international standards are perceived as being more rigorous than their present regimes. By making accounting standards more rigorous, financial information is potentially more transparent and reliable to decision-makers such as investors, lenders and other stakeholders. This transparency also deters corporate fraud and other misreporting, and promotes the prospects of legitimate businesses, as prospective investors and lenders are more likely to provide capital at lower premiums for risk where any uncertainties are reduced.

39 Countries that already have rigorous accounting standards are also trending towards adoption to increase the potential for capital raising through improving the comparability (and hence transparency) of financial data across jurisdictions. This cross-border comparability facilitates international investment, enabling entities to access to access global capital at cumulatively lower cost. It should, however, be noted, that some individual entities may experience greater difficulty in capital raising due to weaker balance sheets and greater perceptions of risk following adoption of IFRS and corresponding accounting recalculations.

40 In addition, there are reduced compliance costs for multinational corporations because financial reports filed by subsidiaries for local regulatory purposes are prepared according to the same set of standards as the reports prepared for their parents for consolidation purposes. Finally, accounting skills learned in one jurisdiction may be more readily transferable to other countries.

41 Related to the above points, benefits also flow from being *perceived* to comply with international norms and standards. A country that is seen to have a rigorous set of internationally compliant financial reporting standards is likely to be a more attractive investment destination.

42 The International Financial Reporting Standards ("IFRS") promulgated by the IASB are likely to become a key measure of the integrity and maturity of a nation's financial reporting regime. These international standards are being, or have been, adopted, by approximately ninety economies, including Hong Kong, Singapore, China, the members of the European Union and Australia. It should, however, be noted that only Australia will have near-universal application of international standards. IFRS will only apply to public issuers in the European Union, and only to companies in Hong Kong and Singapore. Notable countries not adopting IFRS include Canada, Japan and the United States.

¹⁶ See generally <http://www.iasb.org>

THE NORWALK AGREEMENT

43 Although the United States will not be adopting IFRS, the IASB and the United States Financial Accounting Standards Board ("FASB")¹⁷ have signed a memorandum of understanding ("the Norwalk Agreement") acknowledging the two boards' commitment to developing compatible high-quality accounting standards.

44 This memorandum includes both a short-term project aimed at removing a variety of individual differences between the United States and the international requirements, and the removal of more substantive differences through a longer term co-ordination arrangement.

45 This project is currently underway, the IASB and the FASB having recently released a joint discussion document,¹⁸ with more planned. This project is likely to conclude by late 2005.

THE INTERNATIONAL FEDERATION OF ACCOUNTANTS – PUBLIC SECTOR COMMITTEE

46 Although IFRS are gaining strong support internationally, given the size of the project, many areas are comparatively undeveloped. In particular, IFRS have virtually no application outside of the profit-seeking sphere. As a general point, the quality of reports produced by public sector entities is widely regarded as being inferior to those of the private sector. For example, many governmental agencies internationally still provide their reports on a cash accounting basis. The shortfalls of this approach have recently been highlighted in relation to the United States federal deficit by a number of commentators.¹⁹

47 However, this area has been addressed by other organisations. The International Federation of Accountants ("IFAC")²⁰ is a global organisation of the accountancy profession, representing approximately 2.4 million accountants worldwide employed in a variety of disciplines. It performs a variety of important functions, and is committed to ensuring high-quality accounting practices.

48 The IFAC has a number of committees, including the Public Sector Committee ("IFAC-PSC")²¹ that focuses on the accounting, auditing, and financial reporting needs of national, regional and local governments, and related governmental agencies. As a part of this function, it issues International Public Sector Accounting Standards ("IPSAS"). IPSAS, many of which are based on international accounting standards, are aimed at ensuring governments and government bodies produce financial reports that are of a high standard and useful to those that rely on such reports.

¹⁷ See generally <http://www.fasb.org>

¹⁸ ED 4 on *Disposal of Non-current Assets and Presentation of Discontinued Operations*, issued 24 July 2003, comment deadline 24 October 2003

¹⁹ See, for example, "It's Even Worse Than You Think" by Howell E. Jackson, in the *New York Times*, 9 October 2003; and "Truth and Transparency: The Federal Government's Financial Condition and Fiscal Outlook" by The Honourable David M. Walker, Comptroller General of the United States, 17 September 2003, delivered at the National Press Club, Washington DC

²⁰ See generally <http://www.ifac.org>

²¹ See generally <http://www.ifac.org/PublicSector>

APPLICATION IN NEW ZEALAND

49 In New Zealand, the ASRB announced on 19 December 2002, after consulting with key parties, including Ministers, that it had decided New Zealand entities should be required to adopt international standards for reporting periods commencing 1 January 2007, with the option to adopt for reporting periods commencing 1 January 2005. This early "opt-in" option is primarily to allow dual-listed entities, that will be required to prepare financial statements according to international standards from 2005 due to other countries' requirements, to prepare a single set of reports.

50 Throughout 2003, the ASRB, ICANZ and others have been working to implement the ASRB decision, and entities, particularly large companies and public issuers, have been determining the likely impact on their financial reports, preparing for necessary changes to their accounting systems, and considering the impact on their financing arrangements. However, although there is a reasonable public awareness of IFRS, significant education about the actual impacts of the adoption of IFRS is desirable. This is likely to be particularly relevant for entities outside the category of large companies and public issuers.

51 Although New Zealand already has very rigorous accounting standards that are held in high international regard, New Zealand will still be able to benefit from the adoption of IFRS. Multinational firms in particular will see reduced costs, as there will be no need to reformulate accounts for local requirements.²²

52 However, the most significant advantage to New Zealand from adopting IFRS will be international comparability. International investors will be able to readily comprehend New Zealand financial reports without the need to first expend time and effort to understand New Zealand's financial reporting framework. This in turn may lead to more foreign direct investment, a key factor identified in the government's Growth and Innovation Framework.²³

53 As for other areas of corporate governance and business regulation, there are also benefits that flow from being perceived to comply with the norms and standards that are internationally accepted. Adopting IFRS will ensure that New Zealand remains at the forefront of accounting practice. Further, New Zealand may be a more attractive investment destination if it can demonstrate its compliance with these internationally accepted norms and standards.

54 The adoption of IFRS is also in accordance with Australia and New Zealand's desire to reduce the obstacles to conducting business on a trans-Tasman basis. Australia will be adopting IFRS from 2005,²⁴ and, even in isolation, New Zealand's adoption will be a valuable contribution towards reducing trans-Tasman business costs, as financial reports will be considerably more comparable. Financial reports

²² The Companies Office estimates that in excess of 1,000 companies may fit within this category, with a significant majority from countries that have or will be adopting IFRS

²³ See generally http://www.med.govt.nz/irdev/econ_dev/growth-innovation/index.html. In particular, discussions relating on the benefits of foreign direct investment can be found the Progress Reports for August 2003 – see *Growth and Innovation Framework: Goals for Growth* at page 7, *Growth and Innovation Framework: Benchmark Indicators Report 2003* at page 34, and *Growth and Innovation Framework: Progress Report 2003* at page 12, Ministry of Economic Development, August 2003; available at http://www.med.govt.nz/irdev/econ_dev/growth-innovation/progress.html

²⁴ *Bulletin of the Financial Reporting Council*, 2002/4 - 3 July 2002; Available at http://www.frc.gov.au/content/bulletins/bull_2002_4.asp; see also http://www.aasb.com.au/international/docs/IASB_adoption_strategy.pdf

produced for New Zealand or Australian domestic requirements should also fulfil the requirements of the other jurisdiction.

55 Any advantages that stem from maintaining unique standards (for example, adaptability for New Zealand conditions), may be off-set by the costs of being different, in particular, potentially being bypassed as an investment destination by those that do not understand the differences. This factor is particularly important for small countries such as New Zealand that place comparatively high importance on international investment, as the costs of being different are likely to be proportionally more significant.

56 While corporate New Zealand predominantly supports the introductions of IFRS in principle,²⁵ and other sectors were supportive of a single set of standards based on IFRS, the consequences of such a change will vary. Some individual entities are likely to experience weaker balance sheets and greater volatility in reporting. This may lead to some dissatisfaction as the detail of the changed requirements becomes more apparent.

57 Overall, the adoption of IFRS will be an important step forward, both in New Zealand's financial reporting landscape and in New Zealand's participation of global projects such as this generally.

58 As a general point, it should be noted that this paper does not, for the most part, concern itself with the substantive content of individual accounting standards. The focus is rather on the legal framework surrounding those standards.

²⁵ See, for example, *Corporate Governance Issues Research – Results Report*, commissioned by PricewaterhouseCoopers, February 2003, where 88% of those surveyed (consisting of Chairmen, Directors, Chief Executives, Managing Directors, General Managers and Chief Financial Officers) supported the adoption of international accounting standards

REPORTING ENTITIES

59 A key issue of general application is "who is required to report?" Reporting requirements place a significant compliance burden on entities. These compliance costs can clearly be justified for large or important public issuers and government organisations that are responsible for significant amounts of investor and taxpayer funds. However it is less apparent that the compliance burden is justified for medium-sized enterprises, and even less so for small operations.

60 In October 2002, the Ministry of Economic Development released a discussion document²⁶ outlining New Zealand's exempt company regime. The exempt company regime provides for lesser reporting requirements for companies that fall below certain income and asset thresholds. The discussion document went on to outline the rationale behind such exemptions from financial reporting requirements.

RATIONALE BEHIND SMALL AND MEDIUM ENTITY EXEMPTIONS

61 The Ministry's October 2002 discussion document outlined the following as the typical distinctive characteristics of small and medium enterprises:

- the business is managed by its owners;
- limited internal resources, especially for external "specialist" advice such as lawyers and accountants;
- a high proportion of trade debtors and creditors in their total assets and liabilities; and
- often reliant on short-term loans or overdrafts rather than shareholder capital to finance assets.²⁷

62 The combination of these factors is such that the range of potential users of any financial reports produced by a smaller entity is significantly reduced. The lack of separation between ownership and management means that there is no separate accountability for shareholder or stakeholder monies. Further, it is unlikely that the entity is seeking prospective shareholders or other members who need to evaluate their possible investment or involvement.

63 As a result, some of the accountability and transparency rationales for imposing financial reporting requirements are not applicable to small and medium enterprises. This is compounded by a lack of resources to employ external "experts" to assist in the production of reports. The likely lack of experience in the required law and/or accounting procedures may limit the value of any reports that are produced.

64 This may be further tempered by the usual personal relationships between the management and the owners or stakeholders of smaller entities. An example is the family-owned business with several family members with shareholdings that do not participate in the day-to-day operation of the business. Family members may rely on the relationship with the operator, rather than the accounts produced by that person. Another example is a small incorporated society (for example, a sports club)

²⁶ *Financial Reporting for Small Companies (the Exempt Company Regime)*, Ministry of Economic Development, October 2002; available at http://www.med.govt.nz/buslit/bus_pol/bus_law/financial-reporting/index.html

²⁷ *ibid.*, pages 10-11

where members are often either directly involved as club officers or know the officers personally. Further, the owner-operator of a small business is likely to know many of his/her suppliers and/or debtors personally. The alternatives to general purpose financial reports may also be more widely used in the case of smaller entities. Banks are likely to require special purpose financial reports, tailored to their specific needs, while trade creditors may be more likely to use a credit check.

65 On the other hand, some transparency rationales remain in the fact that the more highly geared nature of a small or medium entity means that banks contemplating lending, or suppliers considering extending credit, may wish to inspect financial reports to evaluate the creditworthiness of the entity (notwithstanding other alternatives).

66 It is also possible to overstate the compliance costs of preparing financial reports, given that similar information is required (although in a different format) for tax requirements. Further, the costs of preparing the raw data for different purposes are likely to decrease as technology advances, in particular, accounting software packages.²⁸

67 Nevertheless, there is still a direct and often significant cost. In the following table, it is apparent that the benefits that flow from requiring financial reporting are likely to be reduced the smaller or less important an entity becomes, while at the same time the costs that result are less easily justified.

Figure 1: Should small and medium entities be required to produce financial reports? Summary of Factors For and Against

	For	Against
Accountability	Assist owners, shareholders or stakeholders in holding management to account	Unlikely to be separation of ownership and management
Transparency	Transparency to external parties (banks, debtors, creditors, employees etc.)	Relationships not usually determined by financial reports – either special purpose reports, personal relationships, credit checks etc.
Monitoring and Enforcement	Record of financial performance	
Internal Governance	Some benefits in financial discipline	
Others		Cost
	Required to disclose similar information for tax purposes	Different requirements for different purposes
		Lack of resources and experience

²⁸ See, in particular, the XBRL project that is currently underway, and referenced websites at note 11, supra

68 New Zealand and most of its major trading partners have therefore decided that, on balancing the rationales for financial reporting with the costs imposed, the full requirements for financial reporting are not justified for small and medium enterprises. Regimes are therefore provided whereby these smaller entities do not have to meet the full requirements. All submissions received in response to the Ministry's October 2002 discussion document supported a proposal to retain reduced reporting requirements for small businesses.

69 Assuming therefore that some form of differentiation is appropriate, further issues are raised in relation to the delineation of large entities from small.

NEW ZEALAND

70 The Companies Act generally requires New Zealand companies to maintain accounting records that record and explain transactions and enable the financial position of the company to be determined with reasonable accuracy.²⁹ However, the more detailed financial reporting, filing and auditing requirements are found in the Financial Reporting Act.

71 Under the Financial Reporting Act, New Zealand has a statutory two-tier system for financial reporting, with a further non-statutory intermediate tier implemented by ICANZ. The top tier consists of "reporting entities," which must prepare full financial statements in accordance with all applicable financial reporting standards. The bottom tier of "exempt companies" (companies that fall below certain asset and income thresholds) must complete a very basic financial report, set out in the Financial Reporting Order 1994.

72 The intermediate tier allows appropriate entities (medium-sized and small entities that cannot otherwise take advantage of the exempt companies regime) to prepare financial reports appropriate to their situation.

The Top Tier

73 The concept of reporting entities includes all companies (other than exempt companies), persons that are deemed to be reporting entities by statute,³⁰ and "issuers."³¹ For the purposes at hand, an issuer includes:

- every person who has allotted securities in accordance with the Securities Act 1978 through an offer made in a registered prospectus or investment statement, or by virtue of an exemption from that Act granted by the Securities Commission;
- every manager of a unit trust; and
- every person that is a party to a listing agreement with a registered stock exchange.³²

²⁹ Companies Act 1993, section 194

³⁰ This category primarily includes public benefit entities, including the Crown, Crown agencies, local authorities and so on. See "Sector Neutrality," paragraph 159 and following, *infra*

³¹ Financial Reporting Act 1993, section 2

³² *ibid.*, section 4

74 However, the Act deems that certain persons are not issuers, most significantly including:

- the Crown;
- local authorities;
- the Reserve Bank; and
- companies that would fall within the provisions of the Securities Act 1978 by virtue of allotting securities, but have less than 25 shareholders.³³

The Bottom Tier

75 An exempt company is defined as a company, other than an overseas company or an issuer, that, in the accounting period for which the financial statements are required:

- has assets less than \$450,000;
- has turnover of less than \$1,000,000;
- is not a subsidiary of another company, nor itself have any subsidiaries,³⁴ and
- Does not have more than 25 shareholders.³⁵

The Intermediate Tier

76 The intermediate tier is defined in ICANZ's *Framework for Differential Reporting*.³⁶ This provides scope for an entity to prepare financial reports that differ from the general norm, but are appropriate to that entity's circumstances. This is consistent with general purpose financial statements' overarching principle of presenting information in a true and fair manner.

77 ICANZ's framework identifies three factors in determining whether an entity qualifies for differential reporting exemptions:

- public accountability;
- ownership-management separation; and
- size.

78 These are used as "surrogates" for determining whether an exemption from the full requirements of financial reporting is justified on a cost-benefit analysis. ICANZ considers that when certain requirements for each of the above criteria are satisfied, the costs of requiring financial reporting are not outweighed by the benefits of such requirements, and hence differential reporting exemptions allowed.

79 In this context, in line with the accountability rationales for financial reporting, an entity is deemed to have "public accountability" if the body is an "issuer" under the Financial Reporting Act as described above, or if the entity has the coercive power to tax, rate or levy to obtain public funds. Public accountability is essentially deemed if the entity is responsible for public monies, whether raised through voluntary

³³ *ibid.*, section 6

³⁴ *ibid.*, section 2

³⁵ *ibid.*, section 6

³⁶ Institute of Chartered Accountants of New Zealand, 1997

contributions or coercive powers. A body with this form of accountability should not be able to avail itself of the differential reporting exemptions.

80 Owner-management separation is important for differential reporting, again on the basis of the accountability rationales. Where management is accountable to distinct owners, shareholders or stakeholders, full financial reporting can bring significant benefits, assisting owners, shareholders or stakeholders in holding management to account for an entity's performance. On the other hand, where the management of an entity also owns it, financial reports will do little in holding management to account, and is therefore not justified on cost-benefit analysis.

81 Again on the basis of a cost-benefit analysis, the differential reporting framework is limited to small and medium entities. Even where an entity is not responsible for public monies, nor accountable to distinct owners, shareholders or stakeholders, requiring financial reports will still bring benefits, in particular in terms of transparency, monitoring and enforcement. Parties such as banks, trade creditors, employees and regulators will typically have a legitimate interest in the performance of any entity. However, larger entities are more likely to have larger numbers of interested persons, and are able to better meet the costs involved. Further, the potential economic impact of a large entity, whether through its activities or in the event of liquidation, is such that the transparency, monitoring and enforcement benefits are likely to be greater. As such, the balance of costs and benefits tends toward requiring reporting by large entities, notwithstanding any lack of public accountability or separation of ownership and management.

82 For this purpose, ICANZ defines an entity as "large" if it exceeds two of the following:

- total revenue of \$5 million;
- total assets of \$2.5 million; and
- 20 employees.

COMPARABLE INTERNATIONAL JURISDICTIONS

The United Kingdom

83 In a similar manner to New Zealand, the United Kingdom places a general reporting requirement on all entities registered under the Companies Act 1985,³⁷ with further specific, detailed obligations on most entities. However, the Companies Act goes on to provide that small and medium-sized companies that meet certain criteria can take advantage of reduced reporting requirements.

84 The United Kingdom has a system with "two-out-of-three" thresholds that a company must fall below to be considered small or medium-sized. A small company is one that has:

- turnover less than £5.6 million;
- balance sheet totals less than £2.8 million; and
- less than 50 employees.³⁸

³⁷ Companies Act 1985 chapter 6, section 221

³⁸ *ibid.*, section 246. Note that these thresholds were raised as of 30 January 2004. See generally http://www.dti.gov.uk/sectors_financial.html

- 85 A medium-sized company must have:
- turnover less than £22.8 million;
 - balance sheet totals less than £11.4 million; and
 - less than 250 employees.³⁹

86 However, certain types of companies cannot avail themselves of the reduced reporting requirements, even if they would otherwise fall below the thresholds. These exceptions include public companies, banking and insurance companies, and certain providers of financial services.⁴⁰

Singapore

87 The Singapore Companies Act⁴¹ sets out the regime for financial reporting, and has recently been modified.⁴² Following these recent amendments, Singapore has a three-tier regime for financial reporting. However, the differential requirements are in relation to audit and filing requirements (see below⁴³) and all companies must maintain accounting records that comply fully with all applicable standards. However, the three tiers of company are delineated as follows:

- *First Tier*: all companies that do not otherwise fit within the second or third tiers, and second and third tier companies ;
- *Second Tier*: "exempt private companies," which must have fewer than 20 persons as shareholders, with no direct or indirect beneficial interest held by any corporation;⁴⁴ and
- *Third Tier*: "small exempt private companies," which have the same 20 shareholder requirement as for second tier exempt private companies, with the additional proviso that its annual revenue does not exceed a prescribed threshold. However, shareholders representing five per cent or more of the company's shares, or the Registrar of Companies and Businesses, can require the company to prepare audited statements. The small exempt private company provisions were one of the recently-introduced amendments, and, as a transitional step, the annual revenue threshold has been set at S\$2.5 million for the first year, but will be raised to S\$5 million after that.

Australia

88 Australia also generally requires all entities to maintain accounting records that correctly record and explain an entity's transactions, financial position and performance,⁴⁵ and then imposes further reporting requirements on certain entities. Australia requires full financial reports to be prepared by all "disclosing entities," "public companies," "large proprietary companies" and all registered schemes.⁴⁶

³⁹ *ibid.*, section 246A

⁴⁰ *ibid.*, section 247A

⁴¹ chapter 50

⁴² Companies (Amendment) Bill 2003

⁴³ Paragraphs 124-127, *infra*

⁴⁴ Companies Act chapter 50, section 4

⁴⁵ Corporations Act 2001, section 286

⁴⁶ *ibid.*, section 292

89 If any of the securities of any body are "enhanced disclosure" securities, then that body is a "disclosing entity."⁴⁷ Enhanced disclosure securities are in turn defined as:

- securities that are included in a licensed market's official list;⁴⁸
- equity securities that have a lodged prospectus;⁴⁹
- managed investment products held by more than one hundred people;⁵⁰ and
- securities that are a part of an off-market scrip takeover offer issued to more than one hundred people.⁵¹

90 "Public companies" refers to listed companies incorporated under state or territory law, predating the Corporations Act.

91 The key distinction, however, is contained in the differentiation of "large" and "small" proprietary companies. A large proprietary company, is, as stated above, obliged to comply with the full requirements for financial reporting. A small proprietary company, on the other hand, is only obliged to prepare full statements if shareholders possessing five per cent or more of the voting rights of that company elect,⁵² or if it is a foreign company,⁵³ or directed to do so by the Australian Securities and Investments Commission ("ASIC").⁵⁴

92 A small proprietary company is distinguished from a large proprietary company if it satisfies two of the three following thresholds:

- its consolidated gross operating revenue for the financial year (including subsidiaries) is less than A\$10 million;
- the value of its consolidated gross assets at the end of the financial year (including subsidiaries) is less than A\$5 million; and
- the company and its subsidiaries have less than 50 employees at the end of the financial year.⁵⁵

COMMENT

93 It is widely considered that the New Zealand approach to differentiating small and medium entities from large can be improved, or at the very least clarified and made more internally consistent. The discussion document released by the Ministry of Economic Development in October 2002⁵⁶ arose from the findings of the Ministerial Panel on Business Compliance Costs,⁵⁷ which in turn arose from the 1998 Commerce Committee Inquiry into Compliance Costs for Small Businesses.

⁴⁷ *ibid.*, section 111AC

⁴⁸ *ibid.*, section 111AE

⁴⁹ *ibid.*, section 111AF

⁵⁰ *ibid.*, section 111AFA

⁵¹ *ibid.*, section 111AG

⁵² *ibid.*, section 293

⁵³ *ibid.*, section 292

⁵⁴ *ibid.*, section 294; see generally <http://www.asic.gov.au>

⁵⁵ *ibid.*, section 45A

⁵⁶ note 26, *supra*

⁵⁷ note 10, *supra*

94 Following stakeholder input, the Ministerial Panel concluded that there were four areas of the Financial Reporting Act that needed review.⁵⁸ Two of these, the complexity of the legislation and its exemption regime, and the unnecessary costs associated with producing financial reports with unclear benefits, relate directly to the regime for reporting requirements of small and medium enterprises. In its October 2002 discussion document, the Ministry further identified that the major problems with the current differentiation approach were its complexity and the inappropriate threshold levels.⁵⁹

95 There are clearly a wide variety of approaches taken on this issue. However, given New Zealand's present framework and business landscape, it does not seem appropriate to introduce the more stringent requirements of Singapore because of the significant costs involved. A better approach would be maintaining a tiered approach to financial reporting requirements, as is also currently the case in Australia and the United Kingdom, providing relief from the full requirements of disclosure for smaller and medium-sized entities.

96 There are, however, issues in the delineation of these tiers. In line with a traditional cost-benefit analysis, the costs involved in preparing financial statements should only be imposed when outweighed by the resulting benefits. In this case, the benefits are those that flow from the rationales for financial reporting as outlined above. However, these benefits do not necessarily accrue in the case of smaller entities and the costs of preparing full financial statements are probably not justified on a utilitarian basis.

97 In acknowledgement of this, the various international jurisdictions outlined above and the statutory New Zealand regime essentially adopt an underlying "economic impact" theory to determine reporting requirements. Those entities with potentially high economic impacts should disclose fully, those with less potential impact to disclose on a reduced basis, and those with little to no potential impact to disclose on an even further reduced basis or not at all.

98 However, determining potential economic impact is subjective. In order to provide certainty, impact is typically equated with certain asset and revenue thresholds, and also, in the United Kingdom, Australia and New Zealand's non-statutory intermediate regime, with employees. New Zealand's current statutory regime also includes whether the company has subsidiaries and whether it is offshore or domestically controlled.

99 Although these measures are all helpful to some degree, they do not necessarily provide a complete solution in themselves. Consideration must be given to the applicability and necessity of the factors. For example, if most entities that cross any two of the thresholds would likely cross the third as well, it is questionable that a third criterion to measure economic impact adds anything.

100 Further, given that it may be desirable to ensure New Zealand has a single set of standards applicable to entities beyond the profit-seeking corporate (see below⁶⁰), some consideration should also be given to the applicability of any thresholds to public benefit entities. Other factors beyond economic impact should therefore be taken into account.

⁵⁸ *ibid.*, Chapter 6.9

⁵⁹ Several more issues were identified with the required content of the financial reports

⁶⁰ Paragraphs 159 and following, *infra*

101 In this respect, the analytical regime of ICANZ's *Framework for Differential Reporting*⁶¹ is superior and provides some potential further factors. Although the accountability rationales can be considered to some degree proportionate to the size of a company, there are other factors within the rationales that do not directly correspond to size alone. ICANZ includes public accountability and owner-management separation, neither of which depends on the size of a given entity. This includes at least some public benefit entities, although limited to those with coercive powers of taxation.

102 ICANZ's broader focus may therefore be more appropriate than an economic impact test alone. This has some backing in the approaches of New Zealand and Singapore, both of which also have regard to the number of shareholders in some manner. If a company is not closely held, management and ownership are likely to be separated and hence there is greater need for accountability. Further, it is also more likely that there is some form of public fund raising in a widely held company, again indicating that requiring disclosure could lead to more widespread benefits.

103 Further precedent for this type of approach can also be found elsewhere in New Zealand law. For example, the Takeovers Act 1993 applies to "specified companies," a criterion for which is 50 or more shareholders. This is predicated on the assumption that in a closely held company (in this case, one with less than 50 shareholders), shareholders are more likely to have access to all the necessary information to make a decision on the merits of a takeover offer. Carrying the same argument across to financial reporting, the shareholders of a closely held company (however defined) are more likely to be kept informed and have access to financial information where necessary.

104 A further issue is the question of which tier is the "default" or "catchall" category. The Financial Reporting Act regime is structured so that it is generally assumed all reporting entities must comply with the full requirements for financial reporting (that is, they are in the "top tier"), unless a specific exemption applies. This may not be entirely appropriate in all circumstances. For example, a very small company with negligible accountability or economic impact could conceivably breach the measures and be subject to the full requirements of financial reporting. Under the current New Zealand regime, an otherwise exempt company can easily fall afoul of the full requirements for financial reporting. A small company with three shareholders would fall outside the exemption if one of those shareholders migrated to Australia, as more than 25 per cent of the votes would be based off-shore.⁶² Another company could exceed the thresholds due to an atypically large transaction or contract that is not likely to be repeated. In both cases, the benefits that would flow from requiring full financial reports are questionable. On the other hand, this is an issue that may be able to be adequately addressed through careful choice and drafting of the thresholds.

105 Closely related to the above point is whether it is desirable to have a form of "opt-in" or "opt-out" requirement for reports. For example, Singapore has a system whereby five per cent or more of the shareholders of an exempt private company can require that company to prepare fully audited financial reports. The reverse would be requiring an entity to produce reports unless some percentage of shareholders elect otherwise. This is one possible way to incorporate the accountability rationale. Where owners, shareholders or stakeholders either do not need management to account (for example, in a closely held company), have faith in the management or are able

⁶¹ note 36, *supra*

⁶² Financial Reporting Act 1993, section 19(1)(c)

to get financial information via an alternate method, the accountability rationale has less impact.

THE ACCOUNTING STANDARDS REVIEW BOARD PROPOSAL

106 Combining various considerations as outlined above, the ASRB has released a proposal⁶³ that, in its opinion, offers the best model for New Zealand financial reporting. The Ministry of Economic Development is seeking comments on this proposal as the basis for discussion as to the best financial reporting framework for New Zealand.

107 In formulating the proposal, the ASRB consulted a number of parties who expressed concern that the application of IFRS to all entities would, in many cases, result in financial reporting where the costs that outweigh the benefits.

108 Drawing on international and ICANZ's models, the proposed structure identifies four proxies. Although these proxies could be considered somewhat arbitrary, there are major benefits in having a high degree of certainty about whether an entity is required to comply with each set of requirements. The proposed proxies are:

- The status of the entity as an "issuer" or otherwise (with issuer accorded its current Financial Reporting Act definition);
- The coercive power to impose taxes, rates or levies;
- A responsibility to report; and
- Size.

109 The first two are largely self-explanatory. In relation to the third, an entity will be regarded as having reporting responsibilities if:

- Its constitution or governing legislation requires the entity to account to the public (or a public official);
- Its office holders are accountable to the general public;
- The elected officers are, or are analogous to, trustees (for example, clubs or member-owned entities);
- The entity has a charitable purpose (as approved by the Inland Revenue Department);⁶⁴
- The entity's ownership is "foreign" (as defined by the Financial Reporting Act); or
- There is separation of ownership and management.

110 Further, in line with the Australian model, the proposal sets out a "two-out-of-three" size test. An entity would be "large" for the purposes of the Financial Reporting Act if it exceeds two of the following (although the Ministry of Economic Development notes that it is likely that any strict numerical thresholds would be able to be changed

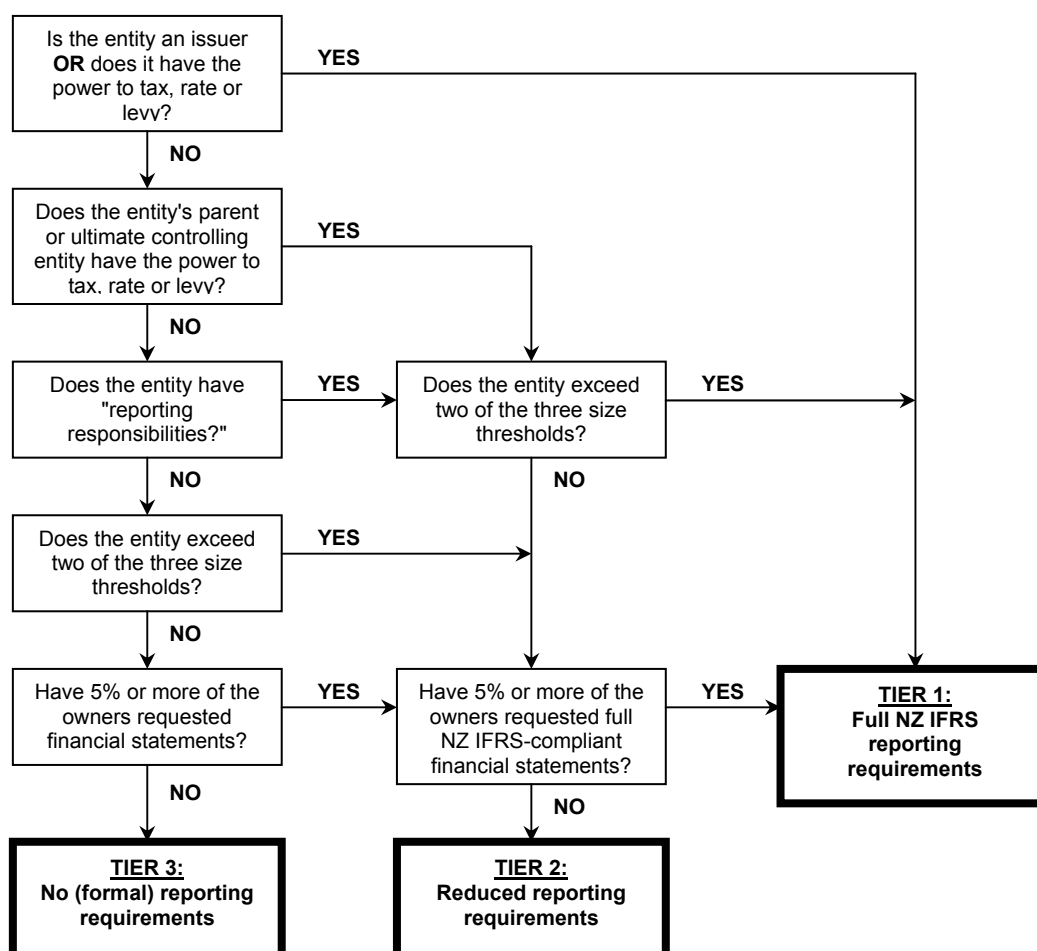
⁶³ See <http://www.icanz.co.nz/StaticContent/AGS/IFRSadoption.cfm#structure>

⁶⁴ Although note the work being done which will lead to the establishment of a Charities Commission which will take over responsibility for this role

easily, either through an additional ASRB power or by the Minister by notice in the *Gazette*⁶⁵):

- More than \$5 million in assets;
- More than \$10 million in revenue; and
- More than 20 full-time equivalent employees.

Figure 2: The proposed financial reporting framework



111 As per the current financial reporting framework, the proposal identifies three tiers of reporting requirements. A combination of the proposed proxies would determine the tier of any given entity. Tier 1 entities would be required to comply with the full reporting requirements of New Zealand IFRS, and would comprise:

- Issuers;
- Entities with a coercive power to tax, rate or levy;
- Large entities controlled by entities with a coercive power to tax, rate or levy;

⁶⁵ The detail of this issue is likely to be considered in Part II of the Review of the Financial Reporting Act as part of the discussion related to the appropriate role and functions of the associated institutional bodies

- Large entities with reporting responsibilities; and
- Entities that would otherwise be in tier 2, but five per cent or more of the owners, shareholders or stakeholders request full financial statements.

112 Tier 1 entities would include listed companies, government departments, and large widely held companies (though not listed). It would also include large charities and clubs.

113 Tier 2 entities would also be required to produce reports, but with some relief from the full disclosure requirements (to be determined by the ASRB⁶⁶). This category would comprise:

- Small public sector entities, unless its controlling entity requests full financial statements, in which case the entity would shift to tier 1;
- Small entities (despite otherwise having reporting responsibilities), unless five per cent or more of the owners, shareholders or stakeholders request full financial statements as above
- Large entities without reporting responsibilities, unless five per cent or more of the owners, shareholders or stakeholders request full financial statements as above; and
- Entities that would otherwise be in tier 3, but five per cent or more of the owners, shareholders or stakeholders request financial statements.

114 Tier 2 entities would include smaller public sector entities (in particular, schools). Significantly, it would also incorporate smaller entities such as clubs,⁶⁷ and large closely held companies. This is a significant departure from current requirements. Large, closely held companies are subject to the full requirements of financial reporting under current New Zealand law, and the proposal would reduce their obligations.

115 Finally, tier 3 entities would have no formal reporting requirements beyond the Companies Act requirements, subject to five per cent or more of the owners, shareholders or stakeholders requesting financial statements. This reflects general feedback on the October 2002 Ministry of Economic Development Discussion Document on the Exempt Companies Regime.⁶⁸ Submissions generally supported the removal of any formal reporting requirements from the Financial Reporting Act as an unnecessary compliance cost, given the perception that the reports produced were of limited use.

116 Typical tier 3 entities would include all entities that are owned or represent only a few people, and would include a significant proportion (probably in excess of 90 per cent) of entities in New Zealand, including virtually all small businesses.

117 However, the ASRB proposal raises the possibility of the ASRB or ICANZ developing an optional "best practice" regime for small entities similar to the current exempt companies regime. In order to encourage the use of this regime, the Ministry of Economic Development believes it may be desirable to provide that entities that comply with these best practice guidelines are deemed to fulfil the general reporting

⁶⁶ However note that the IASB intends to release a report on financial reporting by small and medium entities in September 2004. This may eventually culminate in an international standard for reporting by those entities. This issue will be evaluated following the release of this report and its recommendations.

⁶⁷ See discussion on Entity Neutrality at paragraphs 151 and following, *infra*

⁶⁸ note 26, *supra*

requirements they are required to meet. For example, a tier 3 company, although having no formal reporting requirements, must still comply with section 194 of the Companies Act. Although the best practice regime would be optional, any company that did comply would be assured it fulfilled its other legislative requirements.

THE TRANS-TASMAN PERSPECTIVE

118 It is not necessary to have the same reporting regime as Australia, even should a joint trans-Tasman institution be created. Although this institution may set the reporting standards for both countries, it will still be the substantive law of the individual countries that will establish which entities must comply with the financial reporting requirements.

119 On the other hand, generally co-ordinating New Zealand's reporting requirements with Australia could prove beneficial. As stated above, if both countries are IFRS-compliant, the reports produced in one are almost certain to satisfy the requirements of the other. However, this only applies where both countries require the same sets of financial reports, particularly for smaller entities that do not have to meet the full requirements of IFRS.

120 In this regard, a point of particular significance is that Australia only has two classes of reporting entities (an entity must either fully comply with the reporting requirements or not at all), whereas the ASRB proposal includes tier 2 entities that would still be required to report, but only in accordance with reduced requirements. A New Zealand tier 2 entity would not be able to choose to provide their New Zealand reports for Australian purposes, as they would (most likely) be subject to the full requirements of financial reporting.⁶⁹

Question 1

- a. Do you agree that it is appropriate to have different reporting requirements for different types and sizes of entities in New Zealand? If not, what reporting requirements should there be and why?
- b. If you believe that there should be different reporting requirements for different types and sizes of entity, do you agree with the ASRB proposal on how the different types and sizes of entity should be determined? Are there any additional factors or considerations that you believe are appropriate to consider in determining the tier of a given entity?
- c. Do you agree that the ASRB's proposed two-out-of-three combination of assets, turnover and employees is appropriate? Do you agree that the figures used are appropriate?
- d. Do you agree with the removal of reporting requirements for tier 3 entities under the ASRB proposal? If not, what reporting requirements should there be and why?
- e. Do you believe that optional compliance with a "best practice" guide would prove beneficial? If so, do you agree that meeting the best practice guide should mean automatic compliance with the general reporting requirements (for example, of the Companies Act 1993) through a deeming provision?

⁶⁹ Though note the forthcoming IASB report on small and medium entities, see note 66, supra

- f. Do you agree that the current tier 2 categorisation of large entities without reporting responsibilities, and small entities with reporting responsibilities, is appropriate?
- g. If the ASRB proposal was adopted, are you aware of significant reporting issues that may arise for any entities?
- h. If, instead of the ASRB proposal, a two-tier structure like that operating in Australia was adopted, are you aware of significant reporting issues that may arise for any entities?

AUDITING AND FILING REQUIREMENTS

121 In addition to the obligation to prepare financial reports as described above, certain entities face two further obligations: firstly, the requirement to have their financial statements audited, and secondly, to register those financial statements with the Registrar of Companies.

122 In relation to public sector, the Public Audit Act 2001 requires audit of public entities, and various specific pieces of legislation require financial statements to be "filed" with some authority, such as being tabled in Parliament. This includes State Owned Enterprises, Crown entities, local authorities and government departments. Certain other types of entity also have specific requirements, in particular those such as banks and super schemes. However, the Financial Reporting Act only requires audit⁷⁰ and filing⁷¹ by issuers and foreign companies. Most other comparative international jurisdictions have much broader requirements, and it is therefore appropriate to examine New Zealand's requirements.⁷² It should, however, be noted that this examination does not include a consideration of public sector entities, which are governed by the Public Audit Act. This discussion is therefore limited to other public benefit entities and profit-seeking corporates.

COMPARATIVE INTERNATIONAL JURISDICTIONS

The United Kingdom

123 In the United Kingdom, an entity that meets the requirements for a small company (as described above) is exempt if its turnover is less than £5.6 million.⁷³ In addition, entities that fall within the medium-sized thresholds need only have the reduced reports audited, and the audit report does not need to be filed (although any qualifications on the report must be described).⁷⁴ The auditor must also certify that the company is entitled to take advantage of the reduced reporting requirements by virtue of the fact it falls within the thresholds.⁷⁵ All other companies must have their reports fully audited and file them.

Singapore

124 As stated above,⁷⁶ Singapore has a three-tier regime for financial reporting, with the differences between tiers limited to auditing and filing requirements.

125 All first tier companies must prepare fully audited financial statements and file them the Registrar of Companies and Businesses.⁷⁷

⁷⁰ Financial Reporting Act 1993, sections 15 (issuers) and 19 (overseas companies)

⁷¹ *ibid.*, sections 18 (issuers) and 19 (overseas companies)

⁷² As stated above, Part II of the Review of the Financial Reporting Act is expected to consider issues related to the method of filing. In particular, there is likely to be emphasis on ensuring technical neutrality and adaptability as accepted methods of filing evolve. See, for example, the XBRL project that is currently underway and referenced websites at note 11, *supra*

⁷³ Companies Act 1985 chapter 6, section 249A; See also the discussion on the United Kingdom's reporting requirements at paragraph 83 and following, *supra*, and notes 37-38

⁷⁴ *ibid.*, section 247B

⁷⁵ *ibid.*, section 247B(2)(a)

⁷⁶ paragraph 87, *supra*

⁷⁷ Singapore Companies Act chapter 50, sections 197-201 and 205

126 Second tier exempt private companies must maintain audited accounts that fully comply with the financial reporting standards. However, an exempt private company must only file an annual return and an "exempt private company certificate," the latter of which certifies that the directors, company secretary and auditors believe the company is solvent and has complied with the requirements for a private company. If it cannot file this certificate, a full set of audited accounts, notes to accounts, auditor's report and director's report must be filed.⁷⁸

127 Third tier small exempt private companies must also maintain proper accounting records that comply with financial reporting standards that would allow their accounts to be audited if necessary. However, the requirement for audit is removed, and a small exempt private company must only file an annual return and an exempt private company certificate containing a declaration of solvency that does not need to be signed by an auditor. If it cannot provide such a certificate, it may file unaudited financial statements.⁷⁹ However, shareholders representing five per cent or more of the company's shares, or the Registrar of Companies and Businesses, can require the company to prepare audited statements.

Australia

128 The Corporations Act requires all entities to have their financial reports audited.⁸⁰ However, small proprietary companies (which are not required to produce financial reports unless shareholders request otherwise)⁸¹ are not required to have such reports audited unless that is also requested by shareholders.⁸² All financial reports that are produced (including on-request reports from small proprietary companies) must be lodged with ASIC.

COMMENT

129 In addition to the individual concerns relating to various costs and benefits outlined below, an issue of general concern is determining whether audit and/or filing requirements should correspond directly to the reporting tiers identified above, or whether there should be some separate requirements. Although setting auditing and filing requirements on the basis of tiers is attractive in its simplicity and certainty, it may be desirable to allow separate requirements that will provide for greater flexibility.

130 For example, allowing a "shifting" of audit or filing requirements on the basis of owner, shareholder or stakeholder opt-in or opt-out may prove beneficial. This is particularly applicable in the case of entities that are already in a given tier on the basis of five per cent of the owners, shareholders or stakeholders opting for such a shift. For example, if the owners, shareholders or stakeholders that vote for a tier 3 entity to shift to tier 2 would be satisfied with unaudited, unfiled financial reports, it may be desirable to allow them to decide not to require audit or filing of those reports.

Audit

131 Auditing is essentially concerned with ensuring the reliability of financial reports. The key issue to be addressed in relation to imposing audit requirements is

⁷⁸ *ibid.*

⁷⁹ *ibid.*, sections 197-201 and 205A-205C

⁸⁰ Corporations Act 2001, section 301(1)

⁸¹ *ibid.*, section 293. See also note 52, *supra*

⁸² *ibid.*, section 301(2)

determining which entities should be the subject of such, on the basis of whether the benefits produced are sufficient to displace the costs involved.

132 Requiring audit of financial reports could bring considerable benefits in terms of accountability, as there would be an added layer of oversight of management. However, this is unlikely to have much significance where there is little separation of ownership and management.

133 An audit requirement would also bring considerable benefits in terms of transparency. Any external parties seeking to rely on the reports would be considerably more confident that audited accounts accurately reflect the financial position and performance of the entity. As such, they are more likely to be willing to transact with the entity, and at reduced cost for the lower risk factor. On the other hand, as stated above,⁸³ those dealing with smaller entities may be more likely to do so on the basis of existing relationships or alternatives (such as credit checks or special purpose reports), rather than rely on general purpose financial reports.

134 With regards to the monitoring and enforcement rationales, benefits are likely to flow from audit requirements, as an independent assessment of an entity's compliance with substantive requirements provides greater certainty that the financial reports accurately reflect the position of that entity.

135 These benefits must however be weighed up against the compliance costs involved, particularly in respect of smaller entities. The costs of having financial reports audited can be quite substantial, and may affect smaller entities disproportionately. Imposing a requirement for audit therefore needs to be carefully evaluated.

136 As for requiring financial reports to be produced,⁸⁴ it is apparent that the benefits that flow from requiring financial reports to be audited are likely to be greater for larger or more important entities, while at the same time the costs that result are more easily justified. Correspondingly, requiring audit of smaller and medium-sized entities' financial reports would produce fewer benefits and impose a greater burden.

⁸³ See paragraphs 63-64, *supra*

⁸⁴ See paragraph 67, *supra*

Figure 3: Should small and medium entities be required to have their financial reports audited? Summary of Factors For and Against

	For	Against
Accountability	Greater certainty that reports reflect true position in holding management to account	Often no separation of ownership and management
Transparency	Greater certainty that reports reflect true position when transacting with entity	Relationships not usually determined by financial reports – either special purpose reports, personal relationships, credit checks etc.
Monitoring and Enforcement	Greater certainty that reports reflect true position	
	Independent assessment of entity's compliance with substantive requirements	
Others		Direct cost of audit services

Filing

137 The primary issue in relation to filing financial reports is determining who is entitled to the information contained therein. Filing reports currently has the result of putting the information in the public domain, and therefore, the question becomes "what entities should provide their reports to the public?"

138 In relation to accountability of management to owners, shareholders or stakeholders, little benefit is likely to flow from requiring filing, since owners, shareholders or stakeholders typically are entitled to receive financial reports anyway. Further, for those entities that do not have separation of ownership and management, no benefits will flow from requiring public filing.

139 Requiring entities to file such financial reports could provide significant transparency benefits. A public register of financial reports would be open to all, not just those in sufficiently strong bargaining positions to demand such accounts if not publicly available, as for special purpose financial reports. This consideration may be particularly telling in the case of smaller entities, where a relatively high proportion of total assets and liabilities is likely to be made up of trade debtors and creditors. Further, such debtors and creditors are likely to be similarly situated smaller entities and likely to be without sufficient influence to demand such financial reports. On the other hand, as outlined above, many smaller debtors and creditors may not rely on such reports, even if available.

140 Requiring the filing of financial reports could also bring substantial monitoring and enforcement benefits, simply because the reports would be of public record and therefore able to be accessed by those wishing to make use of them.

141 Further, complying with a requirement to file financial reports that have already been produced is likely to impose only minimal (if any) compliance costs. However, this may be balanced by other negative impacts that result from filing. Public filing could reduce the privacy of natural persons, particularly in the case of

smaller entities. For example, a sole owner-operator's income would be readily discernible (although it can also be considered one cost of doing business). Disclosure of financial information may also have adverse consequences for trade secrets or confidential operational information. For example, an entity operating in a competitive environment may have to disclose information that would allow its competitors to gain unfair advantages. This is particularly true for such structures as franchises and some co-operatives, where reporting and filing requirements are likely to apply to each individual entity that makes up the group. Each individual would therefore have to disclose its own financial information. On the other hand, entities that operate outlets would be able to consolidate all their financial information into one report.

142 Again, as for imposing requirements to prepare reports and to have those reports audited, it is apparent that requiring filing of financial reports is more easily justified in the case of large entities than for smaller:

Figure 4: Should small and medium entities be required to file financial reports? Summary of Factors For and Against

	For	Against
Accountability		Owners, shareholders or stakeholders typically entitled to receive reports;
		Stakeholders etc. may be a part of management for smaller entities
Transparency	Greater access for interested external parties	Relationships not usually determined by financial reports – either special purpose reports, personal relationships, credit checks etc.
Monitoring and Enforcement	Official record of financial reports	
	May encourage compliance with substantive requirements	
Others		Concerns in regard other costs, for example, privacy of natural persons and trade secrets

Alternatives to Filing

143 As stated above, where filing necessitates making information publicly available, the essential question of "who is entitled to the information" becomes reversed, instead asking "what entities should provide their reports to the public?" Although this may be appropriate, in the context of this review it may also be desirable to explore alternatives to making all filed financial reports publicly available.

144 This may be particularly true for smaller entities, where, as identified above,⁸⁵ alternatives to general purpose financial reports, such as credit checks, special

⁸⁵ See paragraphs 63-64, *supra*

purpose reports or even personal relationships may play a more significant role in evaluating the position of the entity.

145 One alternative to requiring statements to be filed is to require a signed "Certificate of Compliance" from the directors (or equivalent) of an entity. Singapore does not require an entity to file its statements, so long as such a certificate is completed and sent to the Registrar.⁸⁶ This could address some of the possible concerns identified in relation to the privacy of natural persons and trade secrets and so on, while still providing many of the benefits that would flow from requiring financial statements to be filed, particularly in relation to monitoring and enforcement. For example, requiring directors to complete a certificate saying that they have complied with the financial reporting requirements would ensure that directors' minds are turned to the issue and that they are aware of their obligations. It would also assist in monitoring compliance with the Financial Reporting Act, as the Registrar would be aware of those that have not filed a certificate. Further, it would assist in the enforcement of the Act, as any director could be made personally liable for signing a certificate that proved to be false (that is, financial records had not been kept).

146 Alternatively, with similar considerations as those above, it may be desirable to introduce a form of "limited" filing whereby the filed reports would not become public record. This could possibly occur by limiting access to regulatory bodies, or by the by the ability to designate certain portions of the report "confidential" and not disclose the information if certain criteria are met, or by some other method.

Ministry of Economic Development Conclusions

147 The Ministry of Economic Development has formed a tentative view that all tier 1 entities should be required to have their reports audited and filed. Further, the Ministry is inclined to exempt all tier 3 entities from any audit or filing requirement.

148 However, although tiers 1 and 3 are relatively easily categorised, tier 2 presents some issues because it will include a diverse range of entities. Tier 2 entities will typically fall within tier 2 due to their small size, or lack of reporting responsibilities. Nevertheless, entities in tier 2 will still have to produce reports and, in order to properly meet the policy rationales for requiring such reports, it may be necessary to require full audit and filing as for a tier 1 entity. As a compromise position, it may be desirable to again allow shifting tier (both up and down) on the basis of owner, shareholder or stakeholder vote.

THE TRANS-TASMAN PERSPECTIVE

149 The trans-Tasman considerations that apply in relation to audit and filing of financial reports are similar to those for requiring financial reports.⁸⁷ Although it is not necessary to have exactly the same reporting structure as Australia, there may be benefits in doing so.

150 The benefits of one country not requiring audit or filing are likely to diminish if the other country does require such audit or filing. For example, if New Zealand does not require a particular entity to have its financial reports audited or filed, but that entity must also comply with Australian law that does require audit and filing, any costs benefits reaped from the New Zealand provisions are likely to be largely undone.

⁸⁶ See paragraphs 126-127, *supra*

⁸⁷ See paragraph 118, *supra*

Question 2

- a. Should audit and filing requirements correspond directly with tiers of reporting entity? If not, what alternatives would be appropriate? A mechanism to allow audit and filing requirements to shift independently of reporting requirements, or some other approach?
- b. Which entities (either of tiers 1, 2 and 3, or some other measure) should be required to have their financial statements audited and why?
- c. Which entities (either of tiers 1, 2 and 3, or some other measure) should be required to file their financial statements and why?
- d. If you do not believe all entities should be required to file financial statements, do you believe some value would be gained from some form of alternative (whether those provided or otherwise) for those that do not file their reports?
- e. Are there any further issues (for example, in relation to trans-Tasman co-ordination or a possible joint institution) that need to be considered?

ENTITY NEUTRALITY

151 New Zealand does not have a uniform financial reporting regime that encompasses all forms of entity. Although the Financial Reporting Act 1993 imposes reporting requirements on a range of entities, such as all forms of issuers, its primary focus is companies registered under the Companies Act 1993. Some other entities are subject to financial reporting requirements, but this is due to specific pieces of legislation, in particular, the Public Finance Act 1989 and related legislation.⁸⁸

152 The ASRB view is that this leaves some gaps and inconsistencies, in particular for entities such as partnerships, incorporated societies, mutuals, and trusts. The reporting requirements (if any) for entities of this sort are typically imposed by the specific legislation under which they are registered, and in some cases, even by case law.

153 Generally, it is inefficient to have a variety of reporting requirements spread over various pieces of legislation that have evolved in an ad hoc manner. However, more significantly, an entity's legal form does not necessarily determine the extent to which potential users might rely on its financial reports. Two entities that are identical other than their registered status under the Companies Act should face the same reporting requirements for the same policy rationales. For example, where there is external accountability, whether to the shareholders of a company or the beneficiaries of a trust, the reporting requirements should be the same.

154 In this respect, New Zealand already has a degree of entity neutrality in respect of issuers. Every entity that issues securities under the Securities Act 1978⁸⁹ or is a party to a listing agreement with a registered exchange⁹⁰ is required to report, regardless of that entity's form.

155 All reporting requirements for other entities would, however, be subject to the same reporting framework as for companies. For example, a partnership that does not have reporting responsibilities or exceed the size threshold should be able to meet the tier 3 requirements as if it were a company.

156 This would, however, typically result in more rigorous reporting requirements for most entities, with corresponding costs. In particular, most clubs (who have officers accountable to its members) would face either tier 1 or 2 reporting requirements, dependent on size. However, the Ministry has anecdotal evidence that suggests many entities already produce financial reports beyond the minimum requirements, some even having these audited.

COMPARATIVE INTERNATIONAL JURISDICTIONS

157 Australia already has uniform financial reporting requirements regardless of legal form, requiring all forms of entity to be registered under the Corporations Act 2001. This in turn subjects those entities to the financial reporting framework of that Act (see above).⁹¹ In this respect, requiring entity neutrality in New Zealand is likely to be a positive step towards any joint trans-Tasman institution.

⁸⁸ See generally discussion on sector neutrality, paragraphs 159-162, *infra*

⁸⁹ Financial Reporting Act 1993, section 4(1)(a)

⁹⁰ *ibid.*, section 4(1)(c)

⁹¹ Paragraphs 88 and following, *supra*

158 On the other hand, both the United Kingdom and Singapore have, like New Zealand, specific statutory instruments requiring registration for specific legal forms, in turn imposing specific reporting requirements.

Question 3

- a. Do you agree that some form of entity neutrality is desirable?
- b. If not, what reporting requirements do you believe entities not currently subject to the Financial Reporting Act 1993 should be required to fulfil?
- c. If you do agree that entity neutrality is desirable, are there nevertheless some forms of entity that should be exempt from the reporting requirements?
- d. Are there any further issues (for example, in relation to trans-Tasman co-ordination or a possible joint institution) that need to be considered?

SECTOR NEUTRALITY

159 Although the adoption of IFRS is well underway, there are some significant issues that remain a subject of debate. An area of specific concern is in relation to accounting standards for public benefit entities. This is of particular concern to New Zealand and Australia, where the current standards are "sector neutral." In a sector neutral standard-setting environment the same standards apply to all entities regardless of whether there is a profit-motive or not.

NEW ZEALAND

160 In the early 1990s public sector accountability was strengthened with the implementation of the Public Finance Act 1989 and the New Zealand government, government departments and Crown entities producing high quality financial statements in compliance with generally accepted accounting practice. Equivalent legislation was also introduced for local authorities and their controlled entities.⁹²

161 In addition to the generally superior reports that are produced, the fact the accounting rules are made by a body independent of the government adds to the integrity and credibility of the statements. Further, as the rules are also followed by the private sector in New Zealand, the comparability and familiarity of the reports that are produced means they are easier to understand, increasing transparency.

162 The move to accounting in accordance with GAAP has also earned New Zealand an international reputation as its experience and expertise grew in dealing with public sector financial reporting issues. New Zealand's reputation as a leading country on public sector financial reporting issues gives it a platform from which to contribute to and influence the development of international standards.

COMMENT

163 IFRS are designed to apply to the general purpose financial statements of all profit-oriented entities. They are not designed to be applied to the public sector entities.

164 However, it is not open to New Zealand to alter IFRS to suit the New Zealand standpoint and at the same time claim international compliance. One of the fundamental reasons for New Zealand adopting IFRS is the comparability that such standards produce. If New Zealand begins altering standards, the underlying rationale for adopting IFRS will be largely undermined. The possible extreme consequence of this would be international investors bypassing New Zealand as an investment destination. Regardless of the motives for doing so, a country that does not fully conform with IFRS runs a very real risk of being perceived as non-compliant.

165 There are two main options for dealing with these issues. First, New Zealand could adopt an alternative international set of accounting standards relevant to the public sector at the same time as the profit-oriented sector adopts IFRS. Alternatively, New Zealand could adapt IFRS to create a set of standards for public benefit entities based on IFRS with additional material, such as existing New Zealand

⁹² Local Government Amendment Act (No 2) 1989, subsequently replaced by the Local Government Act 2002

standards or relevant international standards, sufficient to make the standards relevant to public benefit entities.

166 In order to determine the best approach towards public benefit entity reporting, the different needs of the public benefit sector and the profit-oriented sector need to be established and how these needs can best be managed. New Zealand's experience over the last ten years suggests that standards need to pay particular attention in the following areas:

- *Information to meet user needs:* Stakeholders providing finance to public benefit entities are predominantly funders and financial supporters rather than investors. These groups are primarily seeking information for accountability purposes rather than information about their return on investment;
- *Reporting entity definition:* the boundary of the consolidated reporting entity may have distinctive features, particularly where legal instruments of ownership such as shares do not exist and where entities operate under the umbrella of a parent body but have significant independence and autonomy from that parent body;
- *Assets:* In the public benefit sector assets often represent service potential as much as they do economic benefits. Special consideration needs to be given to the reporting of assets that do not generate cash, where there is little market evidence, and where the provision of an asset or the supply of benefits arising from the asset are provided at non-market rates; and
- *Liabilities:* Rules established regarding the recognition of liabilities need to consider the situation where public benefit entities have commitments, whether general or specific, that do not arise out of market-style transactions, and how to account for this sort of "non-exchange" transaction.⁹³

167 Many of the above issues are not unique to the public benefit sector, but they may require more emphasis and consideration for the accounting standards to be relevant to public benefit entities and to ensure that the desired level of consistency in reporting by those entities is achieved.

ALTERNATIVE INTERNATIONAL STANDARDS

IPSAS

168 The IFAC-PSC has a custom-designed set of standards for the public sector, based on current international accounting standards. These standards are substantially better than the current public sector standards used in most countries and accord with many of the principles of current New Zealand standards.

169 Adopting these standards would mean that New Zealand public sector entities could claim compliance with IPSAS. However, IPSAS are not aimed at the voluntary sector, and therefore standards would need to be implemented for these entities. Further, given the lack of international adoption of IPSAS currently, no major benefit is likely to be derived from international comparability. Finally, the loss of comparability within New Zealand standards is not desirable.

⁹³ For example, how to account for the future "liability" of superannuation payments

GFS

170 One possibility that has been mooted is the idea of the public sector reporting on a GFS (or GFS-GAAP co-ordinated) basis rather than a GAAP basis.

171 Government Finance Statistics ("GFS") is a system produced by the International Monetary Fund ("IMF"),⁹⁴ designed to produce statistics relating to the financial operations, financial position, and liquidity situation of the general government sector or the public sector in a consistent and systematic manner. GFS focuses on financial transactions such as government spending, lending, taxing and borrowing activities.

172 The main advantage of using GFS at a whole-of-government level is that governments produce statistical reports using GFS for other purposes anyway. Producing two such sets of financial numbers, one for statistical purposes and the other for financial reporting, can be considered unnecessary. Further, GFS is an international system that would enable and promote international comparisons.

173 Although GFS include many financial reporting principles and statements on how to account for various types of item, they are primarily designed to produce statistics to inform economic decision making, in particular, policy decisions, of governments. As a result they are aimed at a government sector level of reporting rather than reporting by a public sector entity. They are therefore only relevant in terms of government wide reporting and not for individual public sector or voluntary sector entities.

174 The use of GFS for public sector financial reports has been criticised,⁹⁵ in particular for its disregard for "paper" losses and gains, since they are not a result of market transactions. Also, as a statistical system, it is more focused on issues of classification than the recognition and measurement concerns of accounting standard setters.⁹⁶ This limits the level of assurance that can be provided on the accuracy of the results reported, either by those reporting or by auditors.

175 An international working party representing several organisations, including the IMF, OECD, IASB and IFAC-PSC, is seeking to harmonise different international government accounting and statistical standards, including GFS and IPSAS. However, as GFS is only applicable for the government sector-wide reports at this stage, and due to possible shortcomings of using a statistical system for financial reporting, the Ministry does not recommend the adoption of a form of GFS for public benefit entity reporting.

ADAPTING IFRS

176 In this approach, IFRS would be introduced unaltered as the reporting requirements for profit-oriented entities, thereby enabling New Zealand to claim compliance with IFRS. At the same time, additions or amendments would be made to

⁹⁴ See <http://www.imf.org>, and in particular <http://www.imf.org/external/pubs/ft/gfs/manual/gfs.htm>

⁹⁵ See, for example, the CPA Australia Inaugural Neil Walker Memorial Lecture by Dr Ian Ball, Chief Executive Officer of IFAC, 23 October 2002, available at http://www.cpaustralia.com.au/01_information_centre/16_media_releases/04_speeches/1_16_4_25_speech_ianball.asp

⁹⁶ See generally "Changing to accrual accounting in Central Government" by Dr Noel Hepworth, Chairman of the Institute of Public Finance Ltd and the former director of the Chartered Institute of Public Finance and Accountancy, 15 April 2002, available at http://www.cipfa.org.uk/international/download/pres_nh_15apr02.doc

IFRS to address issues of particular relevance to public benefit entities. This alteration of IFRS in this limited context will not create any problems in relation to New Zealand's ability to claim compliance with international standards – New Zealand would not be claiming any form of international compliance in relation to the public benefit entities, and would be fully compliant with regard to profit-oriented entities. Further, this approach should produce a set of standards that are largely applicable to all sectors, with any derogations from this principle readily identifiable. This will encourage transparency and accountability in the manner that already exists in New Zealand.

177 The ASRB has decided on this approach. The current exposure drafts issued by the Financial Reporting Standards Board provide an indication of the standards that are likely to result for comment.

THE TRANS-TASMAN PERSPECTIVE

178 Australia has a particular focus on creating a separate set of financial reporting requirements through a "harmonisation" of Australian GAAP and GFS, as they face particular challenges in achieving consistency between budget outcomes reported results and audited GAAP-based reported results. Also there is a perceived need for consistent whole-of-government reporting at the State government level. These factors have not impacted the development of financial reporting standards in New Zealand.

179 Owing to the potential issues relating to GFS outlined above, and the inapplicability of the particular Australian policy basis in the New Zealand context, this approach does not appear to have much support in New Zealand, particularly as this may lead to compromised current public sector accountability arrangements. This could be an area where trans-Tasman co-ordination may be more difficult. However, the costs of being different in this area appear to be significantly lower.

Question 4

- a. Do you agree with the approach to sector neutrality being adopted by the ASRB?
- b. Are there implications for the institutional arrangements regarding standard setting for the New Zealand public sector? If so, what are they and how should they be addressed?
- c. Are there any further issues (for example, in relation to trans-Tasman co-ordination or a possible joint institution) that need to be considered?