Regulatory Impact Statement

Approval for the Introduction of the Financial Reporting Bill

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Ministry of Economic Development. It provides an analysis of options to modify and add to previous decisions made by Cabinet in September 2011 on the review of the financial reporting framework.

This RIS should be read together with the earlier RIS dated 28 June 2011 that related to the decisions the government made in September 2011. The same constraints in identifying costs and benefits identified in the Agency Disclosure Statement also apply here, but on a much smaller scale. Only one issue discussed in this RIS has anything other than minor regulatory impacts: Issue A relating to whether audit should be mandatory or optional for large non-issuer for-profit entities, due to the compliance cost savings associated with permitting those companies to opt out.

The main constraint on the analysis in this RIS is that there are many interrelated causes at work in social systems. This means that it can, at times, be difficult to make useful, reliable and nonobvious predictions about the effects of proposed policy interventions. The Ministry has aimed to use general knowledge, practical experience and good sense as a reality check.

There has been limited consultation with non-government stakeholders for the cost-benefit reasons explained in paragraph 75 of the RIS.

None of the changes is likely to have effects that the government has said will require a particularly strong case before regulation is considered.

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11 July 2012

Status Quo and Problem Definition

1. The status quo for the purposes of this RIS is the set of decisions made by EGI on 7 September 2012 on the review of the financial reporting framework.

2. The problem is that some issues have become apparent during the process of drafting the Bill because the existing decisions are not fully consistent with the objectives of financial reporting as discussed in the next section. The issues are discussed below under the specific topic headings and relate to:

   a) Whether an audit should be mandatory or optional for large non-issuer for-profit entities

   b) Opting in or out of preparation – financial statements or annual reports

   c) Identifying the financial markets participants that will have financial reporting obligations

   d) Offence provisions for registered charities and other reporting entities

   e) Whether very small reporting entities should be permitted to prepare on a cash basis as an alternative to accrual reporting

   f) The treatment of entities that are similar to incorporated societies from a financial reporting perspective

   g) Whether very small friendly societies should continue to have an audit requirement

   h) Whether some or all retirement villages should be required to file audited financial statements

   i) Whether a prohibition on a true and fair override should be retained or repealed

   j) Clarification of the powers of the External Reporting Board (XRB) to address non-financial matters in financial reporting standards.

Objectives

The objective of financial reporting

3. The main purpose of financial reports is to promote accountability by the entity's senior management to:

   a. Those who own the entity, either directly (e.g. shareholders of a company) or indirectly (e.g. taxpayers and ratepayers in the case of government entities)

   b. Other stakeholders, such as:

      i. Debt security holders in the case of issuers of securities

      ii. Depositors in the case of banks

      iii. Service recipients in the case of public sector entities

      iv. Donors in the case of charities.

4. Management accountability issues can also arise in the following circumstances:

   i. If an entity is large, because there may be significant adverse impacts on society if the entity fails; and

   ii. If there is separation between management and the owners or members of the entity.

5. The main objective of financial reporting is to balance the accountability benefits to users of the financial statements against the costs to preparers associated with financial reporting. Those costs will always include the costs of collecting additional information for each item that needs to be disclosed. Those reporting entities that are also required to have an audit or assurance engagement carried out and/or publish the financial statements will face additional costs relating to those activities.

The objective for the purposes of this RIS

6. The objective is to introduce a Financial Reporting Bill into Parliament that will better meet the objectives of financial reporting as described above than a bill based on the current decisions.

Regulatory Impact Analysis

A: Whether audit should be mandatory or optional for large non-issuer for-profit entities

The status quo and problem

7. Last year EGI agreed that large[1] companies and other large for-profit entities that are not issuers will be required to prepare general purpose financial reports (GPFR) and have them audited by a licensed auditor, chartered accountant or approved overseas person [EGI Min (11) 19/1, paragraph 5]. This is different from the law as it currently stands in the following ways:

   a) Although large companies are required to appoint an auditor, they can opt out of audit as long as shareholders unanimously agree; and

   b) There are no equivalent provisions for other large for-profit entities.

8. At the time, the information available to officials indicated that the audit requirement would largely confirm existing practice. However, further information subsequently obtained from stakeholders demonstrates that the decision made in September 2011 is likely to lead to unnecessary compliance costs because an audit will add no value in certain circumstances.

[1] A for-profit entity is large if it has annual revenue of $30 million or total assets of $60 million.

The preferred option

9. The preferred option is to have audit as the default position for large non-issuer companies and other for-profit entities but permitting the owners to opt out. This would mean that the current law as it relates to companies would be applied to all for-profit reporting entities that are not publicly accountable, but with a minor modification to fit with another decision made by EGI last year. Rather than unanimity being required for opt-out, the shareholders of large for-profit entities would be able to opt out if agreed to by owners representing 95% of the voting rights.[2]

Benefits and costs of the preferred option

10. Allowing opt-out would have benefits and reduce compliance costs for the following classes of entity:

    a) Large companies that are closely held – An audit may not be useful if the business of the company is relatively simple, is owner-operated and the financial statements are prepared independently of the owner-operators by a suitably qualified person. These conditions are met, for example, in relation to Foodstuffs-licensed supermarkets. Foodstuffs has advised officials that more than half of its 185 supermarkets are large companies as per the test identified in footnote 1. The compliance cost savings of allowing opt out is likely to exceed $2 million a year for the owner operators of those supermarkets. Other entities are likely to be in a similar position, meaning that the compliance cost savings are likely to be higher than this amount.

    b) Large subsidiaries – The most important financial statements for a company that has one or more subsidiaries are the group financial statements because they relate to the total resources under the group's control. An audit of an individual subsidiary might not add much value if the group financial statements have also been audited. In addition, the auditor of the group financial statements must consider whether the subsidiary's activities are likely to have a material impact on the group financial statements. If so, the group auditor is required to carry out appropriate sampling and verification relating to the subsidiary company. It is difficult to know how many companies would be affected or to quantify the compliance cost implications, but it would be reasonable to assume that allowing companies to opt out would save a seven figure sum.[3]

11. The main risk relating to the preferred option is that some shareholders of large companies may choose to opt out in inappropriate circumstances. However, the shareholders are the only persons entitled by financial reporting law to obtain the financial statements for these classes of reporting entity. It is better to leave them to make decisions in the best interests of the reporting entity than to have a blanket statutory audit requirement. Overall, the risk appears to be low.

Other options considered

12. We also considered whether to use a targeted approach that would only permit opt out in the two circumstances described in paragraph 10 above. This option was rejected. There are risks of unintended consequences because there may be other circumstances where opting out would be of net benefit. It would also make the law more complex.

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[2] EGI agreed to the 95% test for all other opt-outs across the financial reporting system for for-profit entities. The 95% rule is preferred over the current unanimity rule to avoid the risk of a disaffected small minority shareholder using the current veto power for non-business reasons.

[3] For example, 40 fewer audits at an average cost of $25,000 an audit would save $1 million.

B: Opting in or out of preparation – financial statements or annual reports

The status quo and problem

13. The Companies Act 1993 requires companies to prepare an annual report which must include financial statements for the last financial year, and the audit report and the auditor's fee (if an audit was completed).

14. The annual report must also state the names of the directors and their remuneration and include information about the state of the company's affairs, the number of employees earning $100,000 or more a year, donations made and particulars of entries in the interests register. However, these requirements can be opted out of if unanimously agreed by shareholders.

15. Last year EGI agreed to replace the current requirements on all non-large non-issuer companies to prepare general purpose financial reports (GPFR) with the following:

    a) For companies with 10 or more shareholders, a default of GPFR preparation, and assurance by a chartered accountant or licensed auditor, but with the ability to opt out of assurance or preparation if agreed to by shareholders representing 95% or more of voting rights agree; and

    b) For companies with fewer than 10 shareholders, a default of no GPFR preparation, but with the ability to opt in to preparation and assurance if required by shareholders representing 5% or more of voting rights.

16. The problem is that it is unnecessarily complex to have one rule for the financial statements (i.e. 95%/5%) and another rule (unanimity) for the rest of the annual report.

The preferred option

17. The preferred option is to apply the same rules outlined in paragraph 15 in relation to the financial statements to the rest of the annual report.

Benefits and costs of the preferred option

18. The main impact of the proposal will be to move the default from preparation to non-preparation of the annual report for the great majority of companies. This will generally be positive because most companies have no need to prepare an annual report. It will have two effects. First, a largely unneeded vote will no longer take place at company AGMs for those that comply with the law. Second, the law will be consistent with what happens in practice in relation to companies that neither prepare the required information nor pass the required motion at the AGM.

19. We are not aware of any material costs associated with the preferred option.

Other options considered

20. We have not been able to identify any other feasible options.

C: Financial reporting for financial markets conduct participants

The status quo and problem

21. The financial reporting obligations for financial markets participants are found in several Acts including the FR Act, Companies Act, Reserve Bank Act, Insurance (Prudential Supervision) Act, Building Societies Act and the Friendly Societies and Credit Unions Act. Those reporting obligations are largely the same – they are required to publish audited financial statements prepared in accordance with GAAP.

22. The problems with the status quo are as follows:

    a) Different enforcement policies, because there are three different regulators;

    b) Different maximum penalties for the same conduct. To illustrate, the maximum fine for failing to comply with an applicable accounting standard on conviction is $100,000 under the FR Act. The maximum liability on conviction for the same offence under the Building Societies Act is $400 or two years imprisonment; and

    c) There is inconsistency between the exemption from financial reporting for certain equity issuers (25 or fewer shareholders) and the test for when the Takeovers Code does not apply (fewer than 50 shareholders with voting rights).

The preferred option

23. The preferred option comprises the following:

    a) To define the following financial market participants as financial markets conduct reporting entities (FMC reporting entities) under the Financial Markets Conduct Bill (FMC Bill):

        i. Issuers of financial products under regulated offers, managers of registered schemes, listed issuers, and, if regulations require, issuers of financial products under exclusions from regulated offers;

        ii. Licensees under the FMC Bill, financial product supervisors, and operators of licensed markets, except independent trustees of restricted schemes and overseas markets;

        iii. Registered banks, licensed insurers, credit unions, building societies and recipients of money from conduit issuers;

    b) To have the following hierarchy of liability for financial reporting contraventions:

        i. Knowing or reckless failure to comply with an applicable financial reporting standard – a criminal offence with the maximum penalties on conviction for an individual being imprisonment of up to 5 years and a fine of up to $500,000 or both, or a fine of up to $2.5 million in any other case;

        ii. Other failures to comply with an applicable financial reporting standard, failure to keep proper accounting records and not having the financial statements audited – civil liability with the maximum penalty being the greatest of the consideration for the relevant transaction, three times the amount of the gain or loss avoided and $1 million in the case of an individual, or $5 million in any other case;

        iii. Infringement offences for minor-compliance-type contraventions, such as failure to keep accounting records in English; and

iv. Powers for the FMA to prohibit further action in respect of a range of conventions, including offers of financial products that are likely to deceive, mislead or confuse. This power will be able to be used against an FMC reporting entity that uses financial statements that are required to be prepared in accordance with GAAP for such purposes.

c) To place all FMC reporting entities on the financial services provider register; and

d) To broaden the exemption from financial reporting for companies that would be issuers by reason only of the allotment of equity shares by changing the qualifying criterion from "up to 25 shareholders" to "less than 50 shareholders with voting rights".

Benefits and costs of the preferred option

24. The main benefits and costs of these changes are as follows:

a. The entities listed in paragraphs 23(a)(i) and (iii) are reporting entities already. The difference is to add some classes of licensees listed in paragraph 24(a)(ii). The reason for requiring licensees to lodge audited financial statements is the same as the reason that they will be licensed: they take, manage or supervise public money and should be accountable for the performance of their functions and duties to the public. Those entities will incur higher financial reporting costs because a separate ledger must be maintained for each required disclosure. However, the total cost is likely to be low because most licensees carry out related activities that would make them FMC reporting entities for other reasons (e.g. they are deposit takers or insurers). The costs are relatively minor given the very large amounts of public money that licensees are collectively responsible for managing.

b. Consolidating the reporting obligations within the FMC Bill will promote consistency in relation to enforcement policies across the range of FMC Reporting Entities because the Financial Markets Authority will be responsible for all enforcement.

c. The proposed liability hierarchy, which is fully consistent with the rest of the FMC Bill, should significantly improve enforcement outcomes in the following ways:

i. Consistency with principles of justice, for the following reasons:

- Criminal liability is consistent with societal values in relation to egregious conduct;
- Civil liability and infringement notices are more appropriate than strict liability criminal offence provisions for less serious and minor unlawful conduct;

ii. General deterrence will be promoted because of the risks of:

- Substantial maximum fines, stigma and the possibility of the loss of liberty for criminal offending;
- Substantial civil liability pecuniary penalties;

iii. Increasing enforcement effectiveness and efficiency by empowering the FMA to issue infringement notices for minor contraventions; and

iv. Protecting investors from future contraventions by empowering the FMA to make financial reporting-related prohibition orders.

d. Changing the equity issuer exemption from up to 25 shareholders to less than 50 voting shareholders will reduce compliance costs. It would also have the benefit of bringing the rule into alignment with the Takeovers Code which applies to listed issuers and other companies that have 50 or more voting shareholders. However, it is difficult to estimate the compliance cost savings because there are no reliable data on the number of companies that would be affected and some companies might continue to be reporting entities for other reasons, particularly if they are large. The risks of companies inappropriately being exempted under the 50 voting shareholder rule are likely to be minimal.

Other options considered

25. There are many penalty and remedy options. However, options other than the preferred option would be inconsistent with the liability hierarchy of the FMC Bill as described in paragraph 23(b).

D: Offence provisions for other reporting entities

The status quo and problem

26. There are different offence provisions across the statute books for financial reporting offences. Most Acts treat financial reporting contraventions as strict liability offences, but with widely varying maximum fines. In some cases imprisonment is provided for. In other cases it is not.

27. There are two problems:

    a. The existing statutes are not consistent with the principle that offence provisions for different classes of reporting entity should be treated the same if the offenders' culpability and the consequences for users are the same or similar; and

    b. The decision made in September 2011 to make registered charities reporting entities raises issues about penalties for failing to comply with an applicable accounting standard. It is reasonable to assume that fewer people will comply if there are no adverse consequences for breaking the law.

The preferred option

28. The preferred option is as follows:

    a. A maximum fine of $50,000 for all serious financial reporting offences; and

    b. For registered charities:

        i. A criminal offence for knowingly failing to comply with an applicable financial reporting standard and a maximum fine of $50,000; and

        ii. No offence provisions for other contraventions.

Benefits and costs of the preferred option

29. It is appropriate for the potential liability for financial reporting offences to be high in the case of offending by FMC reporting entities. Those entities either seek large amounts of money from the public or hold large amounts of public money in a fiduciary capacity on behalf of broad groups of outsiders. As evidenced in relation to some finance company failures, knowing or reckless misreporting can severely harm investors and investor confidence.

30. The consequences of financial reporting offences are generally much less serious for other reporting entities because they do not use, invest or hold public money. We consider that it is appropriate to retain the strict liability approach in other Acts and standardise the maximum fine upon conviction. There are multiple maximum fine level options and there is no "correct amount". We are satisfied that $50,000 is within the appropriate range of options given the nature of the offence and that there is evidence of fraudulent reporting by employees of some larger reporting entities.[4]

31. We have concluded that failure to comply with an applicable financial reporting standard for registered charities should only apply to knowing contraventions. Many smaller charities rely on volunteers with limited accounting skills to prepare financial statements. Although small charities will be able to prepare in accordance with a simple format reporting standard, it is to be expected that inadvertent non-compliance will occur.

32. The power to deregister a charity is a sufficiently effective means to deal with other financial reporting offences, such as failure to file financial statements. Deregistration means that the charity loses its exemption for income tax and the status associated with being a registered charity.

Other options considered

33. We considered whether the tiered liability approach that has been taken under FMC Bill should be applied to other reporting entities. However, we did not recommend this option because it the benefits of taking a consistent approach to offences and penalties in an Act as a whole would be lost. It would be anomalous to add civil liability and infringement notice provisions to Acts that would only apply to financial reporting when the other unlawful conduct in those Acts would continue to be strict liability offences.

34. We also considered whether to link the maximum fine to existing fine levels in other Acts. However, most of the Acts are decades old and the maxima are very low. We did not give serious consideration to the option of retaining imprisonment for financial reporting offences in relation to entities that are not financial markets conduct reporting entities.

E: Accrual or cash reporting for small reporting entities

The status quo and problem

35. Other than registered charities, some other classes of reporting entities include small entities. This includes some entities that are subject to the Public Audit Act, such as reserves boards and cemetery boards. Small Māori incorporations are also reporting entities.

36. There is no consistent treatment of small reporting entities. Some are required to prepare in accordance with GAAP (i.e. accrual accounting) while others, notably reserves boards have the option of preparing cash reports. The problem is that many small reporting entities do not have sufficient resources to prepare accrual accounts regardless of the class of reporting entity to which they belong.

[4] For example a recent study documents many cases of chartered accountants and other employees of larger registered charities deliberately not complying with generally accepted accounting practice. See Rowena M. S. Sinclair *Understandability and Transparency of the Financial Statements of Charities*, PhD thesis submitted to Auckland University of Technology (2010) at Chapter 6.

The preferred option

37. The preferred option is to take the same approach as agreed to by Cabinet last year in relation to registered charities, which is to permit reporting entities with operating expenditure of less than $40,000 to prepare either accrual or cash reports.

Benefits and costs of the preferred option

38. Permitting all micro reporting entities to prepare cash accounts will:

    a. Reduce compliance costs for those that are currently preparing accrual-based financial statements; or

    b. Bring the law into line with current practice for those that prepare cash accounts now even though the law requires them to prepare accrual accounts.

39. The main disadvantage of cash accounting is that it is almost always an unreliable form of reporting because it does not usually require the entity to record and report assets and liabilities other than cash. This can in turn mean that the risks associated with non-cash assets and liabilities will not be adequately managed. That said, very small reporting entities tend not to have substantial non-cash assets and liabilities, so the risks are relatively low.

Other options considered

40. We have not been able to identify any other feasible options.

F: Reporting entities that are similar to incorporated societies from a financial reporting perspective

The status quo and problem

41. In September 2011 EGI agreed that the default provisions for Māori land trusts be aligned with the financial reporting requirements for incorporated societies. It also agreed that, consistent with its role as overseer of Māori land trust deeds, the Māori Land Court will be able to make exceptions to the default rules. It was also agreed that the financial reporting obligations for friendly societies that do not provide insurance services be consistent with those for incorporated societies.

42. The problem is that it is not the right time to be seeking to align other reporting entities' reporting requirements with those for incorporated societies because the Law Commission is currently reviewing the Incorporated Societies Act and plans to report to the Government in March or April 2013. Therefore there is a significant risk that many entities would need to change their financial reporting-related systems twice in a reasonably short space of time if changes were to be included in the current Bill.

The preferred option

43. The preferred option is to not make any change decisions about financial reporting for Māori land trusts and friendly societies that are not insurers until after the Law Commission has reported. The current statutory reporting obligations for those entities would be retained in the meantime.

Benefits and costs of the preferred option

44. The main benefit of the preferred option is to avoid the risk of the relevant classes of reporting entity from having to change their systems twice. There are no significant costs.

Other options considered

45. We have not been able to identify any other feasible options.

G: Audit for small friendly societies

The status quo and problem

46. All friendly societies are required to have an audit carried out. Societies with receipts, payments and total assets that are all less than $50,000 can choose between having the audit carried out by a qualified accountant or by two persons who are not qualified.

47. The problem is that there is little if any value in having an audit carried out by unqualified persons. They are very unlikely to have the required knowledge of accounting and auditing standards or the skills to carry out the audit to the required standard.

The preferred option

48. The preferred option is to remove the statutory audit requirement for friendly societies that have annual payments of less than $40,000. It would be for the members to decide whether an audit would be carried out and, if so, the qualifications of the auditor.

Benefits of the preferred option

49. The benefits of the preferred option are as follows:

    a. For societies that currently meet the triple $50,000 test and choose to adopt the two-unqualified-persons option, time would no longer be spent on an activity that is likely to be of little or any value. The saving would be small because there are only 150 or so friendly societies and only a small proportion meet the triple $50,000 exemption test.

    b. Some societies that do not currently meet the triple $50,000 exemption test will qualify for an exemption under the $40,000 payments rule. This is because the assets amount is usually if not always the highest of the three amounts, and by a considerable margin. We looked at the latest annual returns for 11 societies selected at random and the total assets amount was much higher for all 11. The median ratio of assets to payments was 7:1 and the simple average was 22:1. Of those 11 societies, three were not exempt under the triple $50,000 test but would have been exempt under the $40,000 payments test.[5]

    c. It would reduce the risk that users of the financial statements might obtain excessive comfort from an audit certificate that has been signed by unqualified persons.

Other options considered

50. We considered whether to recommend retaining the triple $50,000 rule. However, there are problems with that option:

[5] (a) *Anchor Lodge of the Druids Friendly Society* (assets $268,543, expenditure $2,048 and income $74,730 for the year ended 31 December 2011); (b) *Ashburton United Friendly Societies Dispensary* (assets $74,620, expenditure $10,412 and income $48,124 for the year ended 31 March 2011); and (c) *Canterbury Frozen Meat Co Ltd – Fairton Employees Sick and Accident Benefit Society* (assets $96,819, expenditure $18,243 and income $15,097 for the year ended 30 September 2011).

a. As discussed above, the triple $50,000 rule in the FSCU Act is, in practice, a $50,000 assets test. An assets test is not a good proxy for determining whether an audit is likely to be of net benefit. Payments is better because it is a reasonable measure of a society's economic activity; and

b. It would be unnecessarily complex, given that the $40,000 payments rule will be used to determine eligibility for cash reporting by not-for-profit reporting entities.

H: Retirement villages

The status quo and problem

51. In September 2011, EGI agreed that all retirement villages would be required to distribute audited financial statements to residents. It also decided that retirement villages which were issuers or were large would be required to lodge the financial statements with the Registrar of Retirement Villages, which would mean that those financial statements would appear on a public register.

52. The problem is that this decision does not fully consistent with one of the purposes of the Retirement Villages Act, which is "to protect the [property] interests of residents and intending residents of retirement villages" because it does not provide for intending residents to obtain access to the financial statements.

The preferred option

53. The preferred option is to have the lodgement requirement extended to all retirement villages.

Benefits and costs of the preferred option

54. The main benefit is to adequately protect the interests of potential residents. The main cost relates to the one-off process of lodging the financial statements with the Registrar each year. This cost would probably be less than $50 per village.

Other options considered

55. We have not been able to identify any other feasible options.

I: True and fair override

The status quo and problem

56. A true and fair override allows a reporting entity to depart from financial reporting standards in certain circumstances. The FR Act states the following about the true and fair override:

> **11 Content of financial statements of reporting entities**
>
> (1) The financial statements of a reporting entity must comply with generally accepted accounting practice.
>
> (2) If, in complying with generally accepted accounting practice, the financial statements do not give a true and fair view of the matters to which they relate, the directors of the reporting entity must add such information and explanations as will give a true and fair view of those matters.

57. Although these provisions are not as clear as they might be, there is a consensus that section 11(1) prohibits a true and fair override. Section 11(2) nevertheless requires the alternative information to be disclosed, but the criterion for directors to determine when they are required to make such disclosures is unclear and no information is given about how to disclose the information or where to disclose it. However, this is a secondary issue. The main issue is that section 11 is inconsistent with IFRS, which New Zealand adopted in 2007. IAS 1 permits an override in the following circumstances:

> 19. In the extremely rare circumstances in which management concludes that compliance with a requirement in an NZ IFRS would be so misleading that it would conflict with the objective of financial statements set out in the NZ *Framework*, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, **or otherwise does not prohibit, such a departure** [our emphasis].

58. The XRB has dealt with the contradiction between s 11 and paragraph 19 by adding the following New Zealand-only paragraph to IAS 1:

> NZ 19.1 Entities that are required to comply with applicable financial reporting standards in accordance with the Financial Reporting Act 1993 are not permitted to depart from a requirement in an applicable financial reporting standard in the circumstances described in paragraph 19.

59. To summarise, the XRB has added paragraph NZ 19.1 to IAS 1 to ensure that the FR Act prevails over IAS 1. There is an obvious inconsistency between paragraphs 19 and NZ 19.1. A choice should be made about whether to retain and clarify the override prohibition or repeal it.

The preferred option

60. The preferred option is to repeal the prohibition. This change would mean that the XRB would decide whether there is to be a true and fair override and, if so, the override criteria and how and where the information would be disclosed. In practice this would mean that paragraphs 19 and 20 of IAS 1 would apply in New Zealand.

Benefits of the preferred option

61. IFRSs are intended for worldwide use and cannot be written to fully anticipate the needs of every country. The international standards setters recognised this and included the override provision in the first international standard to be issued. The main benefit of allowing an override in New Zealand will be to provide scope for reporting entities to provide financial statement users with more reliable information in the rare circumstances in which New Zealand's regulatory settings do not fit with IFRS.

62. There has been one example since New Zealand adopted IFRS in 2007 where the override could well have been used by a significant number of reporting entities absent the prohibition in the FR Act. The standard relating to taxation (IAS 12) became incompatible with New Zealand's situation when it was decided in 2010 that depreciation on investment properties would no longer be tax deductible. The effect was that some reporting entities which had re-valued properties upwards were required to overstate the deferred tax liability under IAS 12. This was potentially misleading for some users of the financial statements and caused widespread concern in the accounting profession.

63. The IASB partially resolved the problem by modifying the rule in IAS 12 in early 2011. However, New Zealand standards-setters will not always have sufficient political power to convince the IASB to give priority to amending an IFRS to deal with an issue that is important to us but not to other jurisdictions. It was helpful in this case that Hong Kong (which also does not have a capital gains tax) had a similar problem with the rule in IAS 12.

Costs of the preferred option

64. The main risk associated with removing the prohibition would be to provide reporting entities with the opportunity to inflate their profits and mislead investors. There is evidence that many reporting entities would do so, given the opportunity.[6] Nevertheless, the Ministry's view is that this risk is low for the following reasons:

    a) The "extremely rare circumstances" override test is very strict;

    b) The IFRS-compliant amounts must be disclosed even if the override is exercised; and

    c) The reporting entity would have to convince the auditor that an override is appropriate. The "Big 4" accounting firms and most of the second tier accounting firms in New Zealand are part of global networks which have robust international practice rules and guidelines on this matter.

65. In addition, there is no evidence of serious misuse of the override in the many countries that permit it. There is no reason to think that New Zealand would be any different.

66. Another risk with the preferred option is that it will de-harmonise New Zealand and Australian law because the Australian Corporations Act 2001 prohibits an override. We consider that this risk is very low. As evidenced by the deferred tax case, the extremely rare circumstances in which the override would apply are mostly likely to relate to a specific regulatory arrangement in New Zealand. There would not be a trans-Tasman harmonisation issue unless Australia had the same atypical regulatory arrangement.

67. In addition, sometimes New Zealand takes the lead on a law reform issue and Australia follows (e.g. personal property securities law). We should not rule out the possibility that Australia will make the same change at a later date, particularly given that permitting the override is the international norm.

Conclusions on the costs and benefits associated with the true and fair override

68. In practice, it will not make a great deal of difference whether the prohibition on the true and fair override is retained or repealed because the override would be used very rarely. However, the more important arguments in relation to this issue point to repealing the prohibition. First, it is inconsistent with broader financial reporting policy because it is the only part of GAAP that is specifically prohibited by legislation. Second, as demonstrated by the deferred tax liability example, allowing an override could at times benefit the users of the financial statements because it will reduce the likelihood that they will be misled. User needs should consistently be treated as the most important driver of financial reporting policy.

J: Clarification of the powers of the External Reporting Board (XRB) to address non-financial matters in financial reporting standards

The status quo and problem

69. The interpretation section of the FR Act states that a "financial reporting standard means a financial reporting standard issued by the [XRB] under section 24 …'. This definition is not very clear, particularly in relation to non-financial reporting that is closely associated with financial reporting, such as service performance standards.

[6] A June 2011 study by Deloitte found 87 of a sample of 100 large New Zealand companies provided 214 alternative non-GAAP earnings or profit measures in sections of the annual report that are not governed by financial reporting law. 80 of the 87 companies reported an alternative "underlying" profit that was higher than the profit calculated in accordance with GAAP.

The preferred option

70. The preferred option is to make it clear that the XRB can make standards in relation to non-financial reporting that is closely associated with financial reporting (e.g. standards relating to service performance).

The benefits and costs of the preferred option

71. The current circular definition of "financial reporting standard" probably means that the XRB already has the power to make standards that address non-financial reporting matters as long as they are closely connected to financial reporting. Thus, the change would not broaden or narrow the scope of the XRB's powers. It would, however, have the benefit of clarifying the law.

Other options considered

72. We have not been able to identify any other feasible options.

Consultation

73. The Ministry issued a discussion paper on the review of financial reporting in September 2009. The relevant process and the outcomes appear in paragraphs 27-41 of the RIS dated 28 June 2011 that was attached to the two cabinet papers that were considered by EGI on 7 September 2011.

74. Of the issues discussed in this RIS:

    a. The issue relating to audit opt-out (Issue A) was brought to our attention in correspondence and through phone calls from stakeholders with a close interest in the matter;

    b. The true and fair override view issue was brought to our attention by the XRB; ; and

    c. The other issues became evident during the process of drafting the Bill.

75. Wider consultation was not considered appropriate for the following reasons:

    a. It could delay the introduction of the very substantial compliance cost reductions associated with the medium and small company reporting reforms by a year. Those reforms must coincide with the 1 April start date for each tax year;

    b. Consultation on the issues discussed in this paper is likely to be of marginal value. We are satisfied that there are no significant gaps in information that would affect our conclusions; and

    c. Stakeholders will have the opportunity to comment on these matters when submissions are called for by the select committee.

76. The following public sector entities were consulted in relation to the issues addressed in this RIS: the Department of Building and Housing, Department of Internal Affairs, Inland Revenue Department, Ministry of Justice, New Zealand Customs Service, Treasury, Charities Commission, External Reporting Board, Financial Markets Authority and Office of the Auditor-General. We worked closely with the External Reporting Board on several issues.

Conclusions

77. Consistent with the objective stated in paragraph 6, we consider that each of the eight changes is better than the status quo.

Implementation

78. Implementation timing is dependent on the timing of the enactment of the Bill. Assuming enactment by mid-2013, the timetable for implementation could be as follows:

    a. The company annual report change: The tax year commencing on 1 April 2014

    b. The offence provision for charities: For financial years beginning on or after 1 April 2015

    c. All other changes: When provisions of the FMC Bill are brought into force, in late-2013 or early-2014.

Monitoring and Evaluation

79. Please refer to the section on monitoring and evaluation in the RIS dated 28 June 2011.