REGULATORY IMPACT STATEMENT

FINANCIAL REPORTING AND ASSURANCE: CONSOLIDATING STANDARDS-SETTING RESPONSIBILITIES WITHIN A CROWN ENTITY

AGENCY DISCLOSURE STATEMENT

1 This Regulatory Impact Statement has been prepared by the Ministry of Economic Development. It provides an analysis of problems relating to the role of the New Zealand Institute of Chartered Accountants (NZICA) in setting financial reporting, and auditing and assurance standards.

2 The Ministry's analysis has been largely based on responses to a discussion document entitled "Review of the Statutory Framework for Financial Reporting" and discussions with stakeholders. The main recommendation is to consolidate all standards-related functions within a reconstituted Accounting Standards Review Board (ASRB), to be called the External Reporting Board (XRB). Submissions demonstrated a strong consensus in favour of this change.

3 Two further pieces of work are required before the policy decisions could be implemented are:

- To support, through Parliament, the Bill replacing or amending the Financial Reporting Act 1993 (FRA) and making any consequential changes to the Institute of Chartered Accountants of New Zealand Act 1996; and

- To issue a discussion document in 2010 on fee and levy regulations that will need to be made to meet the additional fiscal costs of funding the new reporting system.

4 The government has stated that a particularly strong case is needed before regulation is considered. That provision does not apply in this case as the proposals will not impose any new regulation. It will merely result in the transfer of existing statutory functions from NZICA to the XRB. The total costs of the financial reporting system will increase. In addition, the distribution of the costs will change.

Geoff Connor
Chief Advisor
16 February 2010

STATUS QUO AND PROBLEM DEFINITION

The Status Quo

5 Financial reporting standards describe the principles and rules that entities must follow when preparing general purpose financial statements. They cover recognition, measurement, disclosure and presentation issues.

6 The purpose of an audit of financial statements is to provide a high level of assurance that those financial statements are free from material error and can therefore be relied upon by users. Auditing and assurance standards contain mandatory requirements and provide guidance to auditors on how to exercise their judgment when performing audits or other forms of assurance engagement.

7 Under the Financial Reporting Act 1993 (FRA), the responsibilities for financial reporting standards setting is split between the New Zealand Institute of Chartered Accountants (NZICA) and the Accounting Standards Review Board (ASRB), which is an independent crown entity. The Financial Reporting Standards Board (FRSB), which is a board of NZICA, submits draft standards to the ASRB for consideration. Standards approved by the ASRB have the force of law.

8 The responsibility for setting the financial reporting strategy is not clearly defined. In practice, the ASRB and FRSB between them make strategy decisions, sometimes in concert, other times alone. For example, in 2002 the ASRB decided, after consulting with the FRSB, that New Zealand would adopt International Financial Reporting Standards (IFRS). In addition, when the ASRB decided in 2007 to delay the adoption of IFRS for certain smaller entities (pending the outcome of the current review of the financial reporting framework) it did so in response to a recommendation by the FRSB. The FRSB issued the *NZ Framework* and the *NZ Preface*, both of which are important strategy documents.

9 NZICA is responsible for setting auditing and assurance standards for its members. The Professional Standards Board (PSB), which is another board of NZICA, submits draft standards to NZICA's Board for approval. Approved standards are binding on members. However, non-members of NZICA can carry out statutory audits if they belong to an overseas professional accounting body, providing that the Registrar of Companies has approved the individual or the professional accounting body to which they belong. Thus, the standards approved by the NZICA Board have no formal status in relation to overseas-qualified auditors who are not members of NZICA.

10 The way that auditors are regulated is in the process of being changed. At present, NZICA regulates auditors within a broader framework for regulating Chartered Accountants. In October 2009, the Government decided to strengthen the regulatory system by agreeing to:

- Require NZICA and any other approved professional body to license auditors as a specialist profession; and

- Introduce independent oversight. The ASRB will be reconstituted as the External Reporting Board (XRB), and it will monitor and report on the adequacy and effectiveness of NZICA's auditor regulation systems.

11 The Bill is currently being drafted, with a view to introduction in mid-2010 and enactment by March 2011.

12 The annual financial cost of the financial reporting system is $2,950,000, which is split in the following way:

a The ASRB's annual appropriation is $1,125,000. $295,000 is sourced from the Crown while the remaining $830,000 is obtained from Companies Office fees. The ASRB pays $550,000 of its annual appropriation of $1,125,000 to NZICA to contribute to meeting its financial reporting-related costs; and

b The remaining $1,825,000 is, in effect, paid by NZICA members.

Problem Definition

13 There are several problems with the current arrangements:

a Splitting the responsibilities for financial reporting standards between the ASRB and the FRSB makes coordinated service delivery more complicated;

b NZICA's responsibility to approve auditing and assurance standards is inconsistent with the Government's decision to strengthen auditor regulation. A reason for making these changes is to bring New Zealand's system for regulating auditors within the range of international acceptability. It is unlikely that our auditor regulation system would be regarded as fully credible if NZICA were to retain the power to approve audit and assurance standards;

c The central role of the FRSB in financial reporting strategy is inconsistent with governance principles which suggest that the peak body (i.e. the ASRB) should set the strategy. The ASRB is in a better position to determine strategy from a public policy perspective;

d NZICA is not in favour of retaining its standards-related functions. NZICA has stated that it is finding it increasingly difficult to provide the expected transparency in standards setting, including opening meetings to the public and making technical papers available quickly, due to resource constraints. In addition, NZICA relies on volunteers to contribute to standards-setting. NZICA considers there are risks that fewer members will be able to contribute their services in a voluntary capacity; and

e The uncertainty about the application of approved auditing and assurance standards to overseas-qualified auditors who are not members of NZICA is an issue. In practice it would seem likely that the courts would look to NZICA's standards for guidance in a negligence case involving an auditor who was not a member of NZICA. It is unknown how many auditors are affected for two reasons. First, it is not known how many overseas qualified persons are practising in New Zealand. Secondly, NZICA has reciprocal membership agreements with eight overseas professional accounting bodies. Overall, it is likely that only a small proportion of accountants practising as auditors in New Zealand would be affected. Regardless of the number, the legal uncertainty is unsatisfactory.

OBJECTIVES

14 The main objective of financial reporting is to promote high quality financial reporting in order to:

a Provide users of financial statements with information that will assist them to make high quality economic decisions (e.g. whether to buy, hold or sell shares); and

b Promote accountability by senior management to the principals of the entity (e.g. shareholders of companies and donors to charities).

15 Financial reporting standards contribute to that objective by mandating rules and providing guidance on recognition, measurement, disclosure and preparation issues. The standards are aimed at:

a Ensuring that financial statements reflect the economic reality of a reporting entity's financial position and financial performance; and

b Making it easier for users to analyse financial statements by having a comprehensive set of transaction-neutral standards.

16 The purpose of an audit is to provide a high level of assurance that a set of financial statements is free from material error. Auditing and assurance standards contribute to achieving that goal by mandating rules and providing guidance to auditors on how to exercise their judgment when performing audits and other forms of assurance engagements.

17 A further objective is to have a financial reporting system that is credible, consistent with international practice and provides for coordinated service delivery.

REGULATORY IMPACT ANALYSIS

Options

18 The options are to:

a Retain the status quo;

b Transfer all standards setting responsibilities from NZICA and the ASRB to a regulator;

c Transfer all standards setting responsibilities from NZICA and the ASRB to a government department;

d Transfer all standards setting responsibilities to a private sector entity; and

e Consolidate all standards responsibilities within a reconstituted ASRB (The preferred option).

Option (a): The status quo

19 The advantages of the status quo are as follows:

- It would avoid the one-off ASRB/XRB-related costs associated with transfer of responsibilities $1.765 million; and
- It would avoid new annual costs of $1 million. This amount is needed to pay people to do the work that is currently carried out by volunteers, to cover a loss of economies of scope and to meet the additional costs associated with crown entity reporting requirements.

20 The main disadvantage of Option (a) is that modifying the status quo can not solve Problems (a), (b) and (c), all of which are major. In addition, NZICA is not in favour of retaining its standards-related functions.

Option (b): To transfer all standards setting responsibilities from NZICA and the ASRB to a regulator

21 This option would address Problems (a), (c), (d) and (e).

22 The main disadvantages of Option (b) are as follows:

- It would not address Problem (b) because it would not bring New Zealand's standards infrastructure within the range of international acceptability. Standards setting is a specialist function that is generally carried out by a body with the necessary specialist expertise;

- Setting standards is a "soft" form of government regulation. It requires a different organisational culture to that needed for regulators with a policing role. For example, the Companies Office and the Securities Commission have major investigatory roles which may involve taking cases through our adversarial court system. Setting standards is not a policing function;

- A regulator could have a bias towards requiring the disclosure of excessive amounts of information;

- The solution is bigger than the problem. There is no reason to take the ASRB's existing financial reporting approval functions from it;

- A regulator would need to up-skill to a much greater degree than the XRB. There is a greater risk that it would make mistakes while the up-skilling is taking place. It would need to up-skill in two ways. First, it would need to develop expertise in relation to standards setting generally. Secondly, it would need to learn about sectors that are outside the regulator's current range of responsibilities. For example, a regulator of for-profit entities would need to learn about the government sector and private non-profit sector, and the financial reporting needs of users of financial statements prepared by entities in those sectors; and

- It would be inconsistent with the standards infrastructure used in Australia. This could adversely affect the scope for enhancing the levels of transTasman cooperation between the Australian and New Zealand bodies.

Option (c): To transfer all standards setting responsibilities from NZICA and the ASRB to a government department with the responsibility being given to a statutory officer

23 This option would address Problems (a), (c), (d) and (e).

24 The major disadvantage of Option (c) is a major conflict of interest issue. It is of paramount importance for standards setting to be carried out independently of the interests of preparers. A government department would have a conflict of interest because government departments are required to prepare general purpose financial reports. Under this option, there is a risk that the responsible government department would not produce sufficiently robust standards for public sector reporting. This would compromise government entity accountability to Parliament, taxpayers and ratepayers.

25 This option also has some of the disadvantages as listed for Option (b). It would not be internationally acceptable, the solution is bigger than the problem, there would be an up-skilling issue and it would be incompatible with Australia's financial reporting infrastructure.

Option (d): Transfer all standards setting responsibilities to a private sector entity

26 Under this option, a not-for-profit private sector body that is independent of the interests of the profession, preparers and users and has the sole function of setting standards would be established. Option (d) is consistent with the model that is used in the United States of America. In the US, the Securities and Exchange Commission has the statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfil the responsibility in the public interest. That function has, since 1973, been performed by the Financial Reporting Standards Board (FASB). FASB is part of a structure that is independent of all other business and professional organisations.

27 The main advantage of this option is that solves all of the problems listed in Paragraph 13 without having any of the disadvantages of Options (b) and (c). However, there are some significant disadvantages:

- As is evident from Paragraph 26, a public sector entity would need to monitor whether the private sector standards setter is carrying out its role in accordance with the broader public interest;
- Approved financial reporting standards have the force of law. It would be very unusual for Parliament to delegate its powers to make law to a private sector entity. There would have to be a serious deficiency with the independent crown entity model to justify such an unusual arrangement. We are not aware of any such deficiency;
- It raises issues about how to guarantee funding that is both stable in the long term and independent of the interests of stakeholders; and
- There would need to be an impetus to establish an independent private sector body in New Zealand. That impetus does not exist.

Option (e): The preferred option: Consolidate all standards setting within the XRB

28 Under Option (e), all existing standards functions carried out by NZICA would be transferred to the ASRB/XRB. It is the preferred option because it deals with all of the problems listed in Paragraph 13 without having any of the disadvantages of Options (b), (c) or (d). In addition:

- There are strong links between auditing and assurance standards setting and the auditor regulation oversight role that is planned for the XRB because those standards will be an integral part of the system for regulating auditors; and

- The fiscal costs of Option (e) are not materially different from those associated with Options (b), (c) and (d).

CONSULTATION

29 The proposals outlined above were described in discussion documents released simultaneously by MED and the ASRB in 2009. There was a strong consensus among the stakeholders who submitted on this issue in favour of adopting the preferred option. No significant concerns were raised.

30 The Ministry's discussion document did not state that the additional funding associated with the changes would be funded by way of a user pays system. The proposals had not been developed to that level of detail at that time.

31 The only change that we considered making as a result of consultation relates to the way that the XRB would be structured to carry out the full range of its statutory functions. The MED document noted that crown entities have powers under the Crown Entities Act to establish committees, as it sees fit, to carry out its statutory functions. The ASRB discussion document stated that its tentative view would be to establish the two specialist standards setting sub-boards. One sub-board would prepare, expose and approve financial reporting standards. The other would prepare, expose and approve auditing and assurance standards. The XRB members would be responsible for strategy, oversight and governance.

32 There was strong support for the parent board/two sub-board options. However, some submitters stated that it is essential for the standards approval functions to be seen to be independent of the oversight function. Therefore, it should not be left to the XRB's discretion to establish the sub-boards.

33 The State Services Commission and the Office of the Auditor-General do not agree with this point. Separating powers within an agency is inconsistent with the general policy for crown entities. Constraining the XRB in this way may prevent it from establishing the best internal structure. It would also effectively create two quasi-autonomous agencies within the XRB.

34 The Ministry considers that the points made by the SSC and OAG are very sound. Therefore, the recommendation to the Government is to allow proceed with what was proposed in the MED and ASRB discussion documents. The XRB would have the flexibility to make arrangements for exercising its statutory powers in the way that it sees fit, subject to the requirements of the Crown Entities Act.

CONCLUSIONS AND RECOMMENDATIONS

35 The status quo can be continued in the short term but it is unsustainable. In addition, Options (b), (c) and (d) all have major weaknesses. Our conclusion is that Option (e) is superior to all of other options by a large margin. In addition, the financial costs of Options (b)-(e) are not materially different. Therefore we are recommending that the strategy, financial reporting and audit and assurance standards responsibilities be consolidated within a reconstituted ASRB.

IMPLEMENTATION

36 The current arrangements are set out in the FRA and the NZICA Act. Legislation will be needed in order to implement the changes. The intention is to add these changes to the Auditors Bill, which is currently being drafted with a view to introduction in mid-2010 and enactment by March 2011. The XRB would come into existence on 1 July 2011 and it would take over all standards-making functions on that date.

37 A major transitional issue relates to the funding of the XRB. The intention is to fund the new functions through fees and levies imposed on the beneficiaries of the financial reporting system. Those fees will not be able to be applied until after the amending legislation has been passed. This raises two issues:

- It points to a need to have the legislation enacted in time for the fees and levies to apply in 2011/12; and
- To ensure that the ASRB has sufficient resources to fund the transition costs that it will incur in 2010/11. The Ministry is working closely with the ASRB on this issue.

38 There are also major transitional issues for the ASRB. At present, the ASRB has no staff or premises. It will need both, due to its new auditor oversight and standards functions. The Output Agreement between the Minister of Commerce and the ASRB states that the ASRB should keep the Ministry informed of progress and to provide early advice of any significant risks that might arise.

MONITORING, EVALUATION AND REVIEW

39 The main objective of these reforms will be to have a financial reporting system that is credible, consistent with international practice and provides for coordinated service delivery.

40 The only monitoring needed to determine whether the reforms are consistent with international practice is to monitor international practice to see whether it is changing. We already carry out such monitoring and will continue to do so.

41 Coordinated service delivery is likely to be achieved by consolidating all of the standards setting functions within the XRB. In addition, there are provisions in the FRA that require NZICA to carry out due process when going through the process of preparing new standards. That requirement will be transferred to the XRB.

42 The most important monitoring will be to assess whether there have been any unintended effects. We expect that any significant problems with the changes would become evident within the first two years of the changes being made. Therefore, we will ensure that adequate monitoring occurs in that period. In particular, we will monitor the effectiveness of the changes:

- As part of our ongoing responsibilities to monitor Commerce portfolio entities on behalf of the Crown – To this end, the XRB will be required, by means of the annual output agreements, to provide relevant information in its quarterly reports to the Minister.

- From a Single Economic Market perspective through our membership of the Trans-Tasman Accounting and Auditing Standards Advisory Group – That group is required to report annually to ministers in both countries.

43 If our assessment at the end of the two years is that the structural changes have been successful then, unless there are significant changes to the way that international standards are set, it is unlikely that it would be necessary to undertake a review for at least a decade.