In Confidence

OFFICE OF THE MINISTER OF COMMERCE

The Chair
Cabinet Economic Growth and Infrastructure Committee

Approval to introduce the Financial Reporting Bill

Proposal

1 This paper seeks approval to introduce the Financial Reporting Bill (FR Bill) by 31 July 2012, release a related Supplementary Order Paper that contains amendments to be inserted into the Financial Markets Conduct Bill (FMC Bill) following its enactment, and make some secondary policy decisions to respond to issues that have become evident during the drafting process.

Introduction of the FR Bill

2 Financial reporting law determines which entities are required to prepare financial statements in accordance with the accounting standards issued by the External Reporting Board (XRB). It also determines whether those entities are required to have an audit carried out and whether the entity is required to publish the financial statements (e.g. by lodging them for the purposes of being placed on a public register or having them tabled in Parliament).

3 The FR Bill repeals and replaces the Financial Reporting Act 1993 (FR Act). Some minor and technical changes have been made to the provisions that have been carried over. These changes enhance workability and reflect changes in the financial reporting system since the FR Act was enacted.

4 The FR Bill also gives effect to Cabinet decisions made in September 2011 [EGI Min (11) 19/1 and 19/2 refer]. The main changes can be categorised as follows:

- Removing general purpose financial reporting (GPFR) requirements for small and medium companies. This change will reduce compliance costs, particularly for medium-sized companies;
- Strengthening financial reporting for registered charities by requiring them to report in accordance with accounting standards issued by the XRB. This change is aimed at improving the quality of reporting;
- Making the substantive reporting requirements across the statute book consistent with the objective of financial reporting (i.e., to provide information to external users who have a need for an entity's financial statements but are unable to demand them). This change is aimed at ensuring that all financial reporting obligations are appropriately targeted; and
- Standardising various record-keeping and financial reporting requirements, including those that relate to keeping proper accounting records, complying with accounting standards and the qualifications of auditors. This change will promote consistency and reduce the risk that new inconsistencies will develop over time.

Small and medium companies

5 All companies are currently required to prepare financial statements. Large and medium-sized companies must prepare in accordance with generally accepted accounting practice (GAAP). Small companies must prepare in accordance with the simpler requirements of the Financial Reporting Order 1994. The Bill, insofar as it relates to companies, will only retain the requirement to prepare GPFR for companies:

a. That will be subject to the Financial Markets Conduct Bill, because they seek funding through debt or equity instruments that are offered to the public, take deposits from the public and/or hold assets in a fiduciary capacity for broad groups of outsiders;

b. That are indirectly owned by taxpayers and ratepayers;

c. That are large, because of the potentially significant societal impact if they fail; or

d. Where there is a significant degree of separation between shareholders and management.

6 The great majority of the 550,000-odd companies do not meet any of those tests. The Bill includes the following default/opting rules for non-large non-issuer companies:

a. To have a default position of preparing GAAP-compliant financial statements if the company has 10 or more shareholders, but with the ability to opt out of compliance if agreed to by shareholders representing 95% of the voting rights; and

b. To have a default position of not preparing GAAP-compliant financial statements if the company has fewer than 10 shareholders, but with the ability to opt in if agreed to by shareholders representing 5% of the voting rights.

7 The Taxation (November) Bill will introduce targeted reporting for tax purposes for companies that will no longer be required to prepare GPFR. These changes will reduce compliance costs, especially for medium-sized companies, because the replacement system will only require companies to provide the financial information that the Inland Revenue Department needs for taxation purposes.

Registered charities

8 Registered charities are required to attach financial statements to the report they lodge annually under the Charities Act 2005. However, there are no accounting standards to govern preparation. The absence of standards has led to inconsistent and, in many cases, poor quality reporting, even by some larger charities that employ chartered accountants.

9 In September 2011 EGI agreed that the XRB would issue accounting standards for registered charities [EGI Min (11) 19/1, paragraphs 26-27]. The XRB will introduce two simple format fill-in-the-box standards (one accrual-based, the other cash-based) for the 95% of registered charities with annual operating expenditure of less than $2 million. The remaining 5% will be required to comply with more sophisticated "public benefit entity" standards that will also apply to most public sector entities. The addition of clear rules under those standards will remove uncertainty for preparers, improve the quality of charity reporting, improve charities' accountability to the donating public and increase comparability between charities.

10 There are no requirements for registered charities to have an audit or assurance engagement completed and the Bill does not include anything to this effect. However, there may be changes at a later date for larger charities. The Ministry of Economic Development released a discussion paper in April 2012 entitled *Auditing and Assurance for Larger Registered Charities.* I will report to EGI later in the year about whether any assurance-related changes should be made to the Charities Act 2005.

Other changes

11 Many Acts require entities or classes of entities to prepare financial statements. However, not all of those requirements are consistent with the objective of financial reporting. For example, companies that have one or more subsidiaries must prepare both group and parent company financial statements. The group statements are useful because they relate to all of the resources under the parent company's control. However, the parent company statements are of limited use because they present information about the parent's return on its investments in its subsidiaries, not the underlying performance of the subsidiaries. The Bill includes provisions to remove the parent company preparation requirement.

12 The Bill also includes dollar thresholds to determine certain reporting requirements. For example, certain classes of entity will only have to prepare GAAP-compliant financial statements if they have revenue of $30 million or more or total assets of $60 million or more. The Bill includes a regulation-making power to change the dollar amounts from time-to-time.

The scheme of the Bill

13 Most of the reporting requirements for issuers, registered banks and licensed insurers appear in the Financial Reporting Act 1993. The requirements for issuers largely appear in the Financial Reporting Act. The requirements for companies are split between the Financial Reporting Act and the Companies Act. The requirements for other reporting entities largely appear in legislation other than the Financial Reporting Act. For example, the requirements for incorporated societies and Crown entities appear in the Incorporated Societies Act and the Crown Entities Act respectively. The inconsistent approach is part of the reason that some financial reporting obligations have developed over the decades in ways that are inconsistent with the objective of financial reporting.

14 The scheme of the attached FR Bill is to adopt a consistent approach as follows:

a. All substantive financial reporting requirements, such as the requirement to keep proper accounting records and a requirement to prepare in accordance with GAAP, will appear in sector or entity-specific legislation; and

b. The new Financial Reporting Act that will come into force after the Bill is enacted will include standard definitions and requirements in relation to such matters as auditor qualifications and auditors' access to information.

Supplementary Order Paper to the Financial Reporting Bill

15 Consistent with the model described above, the intention is that the substantive reporting requirements for financial market participants will eventually be included in the Financial Markets Conduct Act (FMC Act). However, Parliamentary practice and procedure means that it is not possible to introduce one Bill in anticipation that another Bill will be enacted. It is, however, acceptable to table an SOP that anticipates the enactment of another Bill, given that an SOP comprises proposed amendments that may be withdrawn at any time.

16 As a result, the substantive reporting obligations for financial market participants are currently set out in an SOP to the Financial Reporting Bill rather than being drafted into the Bill itself. Once there is an FMC Act, the amendments set out on the SOP will be incorporated into the Financial Reporting Bill. If the FMC Act is passed as expected in late 2012, this will likely be done by the select committee considering the Financial Reporting Bill. .

Secondary Policy Issues

17 I am also seeking the following policy approvals to vary and add to the earlier decisions made by EGI in September 2011. The Bill and SOP have been drafted to reflect the following proposals:

A. To replace an earlier decision to require large non-issuer for-profit entities to have an audit carried out with a default position of audit with the owners being able to opt out;

B. To broaden an earlier decision relating to default/opting rules for non-large non-issuer companies from only covering the financial statements to covering the full annual report;

C. To identify which financial markets participants will have financial reporting obligations (FMC reporting entities);

D. To add an offence for knowing non-compliance with accounting standards by registered charities;

E. To standardise the offence provisions for other reporting entities;

F. To permit very small reporting entities to prepare cash rather than accrual financial statements;

G. To not align reporting requirements for Māori land trusts and friendly societies with incorporated societies in this Bill;

H. To repeal a requirement imposed on very small friendly societies to have an audit carried out;

I. To require all retirement villages to file audited financial statements; and

J. To repeal the prohibition on a true and fair override;

K. To clarify that the XRB can address non-financial matters in financial reporting standards.

18 These matters are discussed below.

A: Audit for large non-issuer for-profit entities

19 Last year EGI agreed that large companies and other large for-profit entities[1] 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]. I am seeking to have this decision varied by permitting shareholders of large for-profit entities to opt out of audit. This approach would be largely consistent with the current rules under the Companies Act 1993.[2]

20 I am recommending this change because audit provides little or no additional value for a small proportion of large non-issuer for-profit entities. In particular, an audit is likely to be of little or no value in the following cases:

a. A large closely-held company that operates a relatively simple business, particularly if the financial statements have been prepared by an independent qualified accountant.

b. A large company that is a subsidiary of another company, as long as the group financial statements have been audited. The group financial statements are more important than the subsidiary financial statements because the group statements relate to the total resources under the parent company's control. In addition, the auditor of the group financial statements needs to consider whether the subsidiary is likely to have a material impact on the group financial statements. If so, the auditor will need to carry out sampling and verification processes in relation to the subsidiary.

B: Opting in or out: financial statements versus annual report

21 The Companies Act 1993 requires companies to prepare an annual report comprising:

a. Financial statements prepared in accordance with GAAP;

b. The audit report and the auditor's fee, if an audit was completed; and

c. Information about the state of the company's affairs, the names of the directors and their remuneration, employees earning $100,000 or more a year, donations made and particulars of entries in the interests register. However, a company can opt out of this requirement if the shareholders unanimously agree.

22 In September 2011 EGI agreed to replace the current requirements on all non-large non-issuer companies to prepare financial statements in accordance with GAAP 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% of the voting rights; 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 the voting rights [EGI Min (11) 19/1, paragraph 7].

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

[2] The only difference is that opt-out currently requires unanimous shareholder support, while the Bill has a 95%-of-voting-rights test. This change is being introduced to remove the risk of a minority shareholder imposing unnecessary compliance on the company for non-business reasons.

23 I am recommending that the substantive default and 5% or 95% opting rules described in paragraph 22 be used to cover the whole annual report, not just the financial statements and audit report.

C: Financial markets conduct reporting entities

24 There are four issues in relation to FMC reporting entities:

i. Defining FMC reporting entities;

ii. Consolidating financial reporting obligations for FMC reporting entities in the FMC Act;

iii. The scope of an equity issuer exemption; and

iv. Offence provisions for failing to comply with financial reporting standards.

Issue C (i): Defining FMC reporting entities

25 There is an issue relating to which entities that will be regulated under the FMC Act should be required to file audited financial statements or, to put it another way, be classified as "FMC reporting entities". I am recommending that the following financial market participants be defined as FMC reporting entities:

a. Entities raising funds from the public including issuers of financial products under regulated offers, managers of registered schemes, listed issuers, recipients of money from conduit issuers and, if regulations require, issuers of financial products under exclusions from regulated offers;

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

c. Entities required to be licensed under other legislation including registered banks, licensed insurers, credit unions and building societies.

26 The entities listed in paragraph 25(a) and (c) already are reporting entities. I am proposing that the newly licensed entities listed in paragraph 25(b) also be required to file audited financial statements prepared in accordance with GAAP. The rationale for imposing financial reporting obligations on these entities is the same as the reason the government decided that they should be licensed: they take, manage or supervise public money and should be accountable for the performance of their functions and duties to the public. In practice, this change will make very little difference because most licensees will be FMC reporting entities for other reasons.

Issue C (ii): Consolidating financial reporting for FMC reporting entities in the FMC Act

27 At present, almost all financial market participants are required to prepare financial statements and many have public filing obligations. Most of these obligations arise under the Companies Act and the Financial Reporting Act, but there are preparation and filing obligations under other financial markets legislation, such as the Building Societies Act and the Unit Trusts Act.

28 I am recommending that the financial reporting obligations for financial markets participants that are publicly accountable be consolidated in the Financial Markets Conduct Act (FMC Act). There will be two main benefits:

a. It will promote consistent enforcement policy because the FMA will be responsible for regulating financial practices by all of those entities; and

b. It will mean that the more flexible, modern and relevant range of penalties and remedies in the FMC Act will be available in relation to contraventions of financial reporting obligations by financial markets participants. Unlike the Acts that currently include those financial reporting obligations, the FMC Act will have the following targeted hierarchy of penalties and remedies:

   i. Criminal penalties targeted at egregious violations that involve knowledge of wrongdoing or recklessness;

   ii. Civil pecuniary penalties for other significant contraventions;

   iii. An infringement notice system for minor compliance-type contraventions; and

   iv. An FMA power to prohibit further action in respect of a range of contraventions, including offers of financial products that are likely to deceive, mislead or confuse.

29 I wish to note one technical issue that has arisen though the drafting process. Not all FMC reporting entities have the same level of public accountability. For example, investors in a managed investment scheme have an interest in the financial statements of the scheme and the manager of the scheme. It is reasonable to assert that there is higher public accountability in relation to the scheme because if the scheme becomes insolvent then investors may lose some of all of their money. However, if the manager becomes insolvent, the responsibility for managing the scheme can be passed to another person without investors necessarily incurring any losses.

30 The tiers of financial reporting are set by the XRB. While the XRB has broad discretion to set tiers, experience under the FR Act and discussions with the XRB suggest that if the law does not distinguish between levels of public accountability, the XRB is likely to automatically place all FMC reporting entities in the highest tier. The FMC Act will therefore indicate which entities are considered to have a higher level of public accountability and provide for the FMA to move entities between the levels. This indication will be a mandatory consideration for the XRB when it determines financial reporting tiers under the FR Bill.

Issue C (iii): The scope of an equity issuer exemption

31 The FR Act states that a company is not an issuer for financial reporting purposes if it has no more than 25 shareholders and is an issuer by reason only of the allotment of equity securities. I am recommending that the rule be changed from no more than 25 shareholders to fewer than 50 voting shareholders for the following reasons:

a. It would be consistent with the Takeovers Code. The Code only applies to companies that are listed on a registered stock exchange and other companies that have 50 or more voting shareholders; and

b. It would bring New Zealand's law closer to Australia's. The Australian Corporations Act 2001 provides for six classes of company comprising four classes of public company and two classes of proprietary company. One of the eligibility criteria for registration as a proprietary company is to have no more than 50 non-employee shareholders.

32 This change would mean that a company that makes a regulated offer of ordinary shares will not have to publish its financial statements if it is not a code company and is not otherwise a financial market participant.

Issue C (iv): Offences for failing to comply with financial reporting standards

33 The FR Act treats all non-compliance with applicable financial reporting standards by issuers as criminal offences and every director is liable on summary conviction to a fine not exceeding $100,000. The other Acts that currently apply to FMC reporting entities also treat all non-compliance with standards as a criminal offence but with different maximum penalties.

34 This approach does not fit well with the criminal/civil/infringement notice/prohibition order framework in the FMC Bill because it does not distinguish between misreporting caused by fraud and error. I consider that a criminal offence should only relate to fraudulent reporting. Knowingly not complying with applicable standards is egregious because, as evidenced by fraudulent reporting by some finance companies, investors can be misled and lose large amounts of money.

35 In addition, the current focus on directors is too narrow and should be extended to the issuer. Fraudulent reporting can be knowingly carried out by other persons with or without the knowledge of the directors. Overseas experience shows that there can be risks of fraudulent reporting by senior management, particularly if their remuneration packages include incentive elements that give a high weighting to the entity's short term profitability. The offence provision should therefore apply to anyone who knowingly commits the offence, not just the directors. Under the accessory liability rules in the Crimes Act, this will result in senior managers and others who aid and abet the issuer's contravention to also be liable, even if the directors did not know about the offending.

36 It would be proportionate to other criminal offence provisions in the FMC Bill for the liability on conviction to be up to 5 years imprisonment and a fine of up to $500,000 or both for an individual, or a fine of up to $2.5 million in any other case. The proposal for individuals would also be proportionate to the false accounting offence in the Crimes Act, which is punishable by imprisonment for up to 10 years.

37 It would be appropriate for civil liability to apply for non-compliance with accounting standards other than knowing contraventions. Consistent, with the FMC Bill, I am recommending that the maximum pecuniary penalty be 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.

D: Offences for registered charities

38 The introduction of accounting standards for registered charities noted earlier in this paper raises issues about the consequences for non-compliance with those standards. The main problem is that some charities actively lower their assets or income so that the charity looks poorer than it actually is. The emphasis on looking poor is a result of some funders preferring to fund charities that 'need' the funds rather than charities that are financially sustainable.

39 I am recommending that it be a criminal offence for knowing failure to comply with an applicable financial reporting standard. This change will provide incentives on charities that actively lower their assets or income to stop this undesirable practice. However, the consequences of fraudulent financial reporting are less serious than is the case for FMC reporting entities both in scale and impact on third parties. I am therefore recommending that the maximum penalty to be a $50,000 fine.

40 I am also recommending that there be no offence provision for unintentional non-compliance with accounting standards by charities. Most charities rely on volunteers to prepare financial statements, many of whom have limited bookkeeping or accounting skills. Even though 95% of charities will only be required to comply with a simple format standard, it is to be expected that there will be some inadvertent non-compliance.

E: Standardising offences for other reporting entities

41 There are wide discrepancies in the maximum penalties for contravening financial reporting obligations. Some Acts include imprisonment for financial reporting offences. Others have maximum fine levels that are very outdated (e.g. $100 in the Industrial and Provident Societies Act 1908). I am recommending that the maximum penalty for financial reporting offences be a fine of $50,000 for reporting entities other than the classes discussed above.

F: Cash reporting by very small reporting entities

42 Most reporting entities are required to prepare financial statements on an accrual basis.[3] In September 2011 EGI agreed that registered charities with annual payments of less than $40,000 would, as an alternative to preparing accrual-based simple format financial reports, be able to prepare simple format reports on a cash basis. This decision acknowledges that most small charities do not have the capacity to prepare accrual-based financial statements.

43 Officials have since found other examples of small reporting entities, but there is no consistent practice. Reserves boards that have annual revenue of less than $50,000 and net assets of less than $200,000 may prepare financial statements on a cash basis. Cemetery boards are also permitted to prepare on a receipts and expenditure basis. Māori incorporations are required to prepare accrual financial statements no matter how small they are.

44 There is no reason for having different rules for different classes of small reporting entities. I am therefore proposing that a consistent policy be adopted in accordance with the decision made last year in relation to registered charities (i.e. to permit cash reporting for reporting entities with annual payments of less than $40,000).

G: Māori land trusts and friendly societies

45 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. EGI also agreed that the financial reporting obligations for friendly societies that do not provide insurance services be consistent with those for incorporated societies.

46 I am seeking agreement to not align those provisions with the requirements for incorporated societies in this Bill at present. The Law Commission is currently reviewing the Incorporated Societies Act 1908 and the Commission may recommend financial reporting-related changes. It would be prudent to wait for the Law Commission's report before making any changes premised on consistency with the treatment of incorporated societies.

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[3] Accrual accounting requires revenue and expenses to be recognised when they are incurred regardless of when cash is exchanged.

H: Audits for small friendly societies

47 All friendly societies are required to have an annual audit carried out. There are two rules relating to the qualifications of the auditor. Most societies must have the audit carried out by a qualified accountant. However, societies with receipts, payments and total assets that are all less than $50,000 may instead appoint two or more persons who are not qualified auditors. The latter approach recognises that it can be difficult for small friendly societies to engage qualified persons to carry out an audit at an affordable price.

48 However, allowing two unqualified persons to do the work is an unsatisfactory way of dealing with the problem because auditing is a task that requires specialist skills. It would be better to exempt smaller societies from the audit requirement than give the users false comfort about the reliability of the financial statements. Therefore, I am recommending that the audit requirement for small societies be repealed. It would be for the members to decide whether to appoint an auditor and, if so, the qualifications of the person.

I: Retirement villages

49 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 the financial statements would appear on a public register.

50 I am now seeking to have the lodgement requirement extended to all retirement villages. This change would be consistent with one of the main purposes of the Retirement Villages Act, which is "to protect the [property] interests of residents and intending residents of retirement villages". The requirement to distribute them to existing residents achieves most of that objective. However, lodgement is needed to adequately protect the interests of intending residents.

J: True and fair override

Background

51 A true and fair override allows a reporting entity to depart from the recognition and measurement rules in accounting standards if management concludes that compliance with the standards would conflict with the objectives of financial reporting. The FR Act currently prohibits a true and fair override.

52 Accounting standards did not deal with the true and fair override issue when the prohibition in the FR Act was enacted about 20 years ago. However IFRS, which were adopted by New Zealand in 2007, addresses this issue (in IAS 1). The main issues that should be considered in relation to whether the prohibition in the FR Act should be repealed are:

a. Whether there are effective constraints on reporting entities from misusing the override to inflate their reported profits;

b. The potential benefits to users of financial statements;

c. International practice, including Australian practice; and

d. The treatment of public benefit entities.

Potential misuse of the override

53 GAAP applies only to the financial statements that appear at the back of the annual report. The entity is permitted to give alternative unaudited financial information elsewhere in the annual report subject to prohibitions on misleading statements under securities law and other legislation. There has been a worldwide trend in recent years for issuers to report profit numbers near the front of the annual report (e.g. in the overview, the chairman's report or the CEO's report) that differ from the profit reported in the GAAP-compliant audited financial statements at the back of the report.

54 The New Zealand Institute of Chartered Accountants has criticised this practice, referring to it as "companies develop[ing] the profit they like". A June 2011 study by Deloitte found that 87 of a sample of 100 large New Zealand companies provided 214 alternative non-GAAP earnings or profit measures. 80 of those 87 companies reported an alternative "underlying profit" that was higher than the profit calculated in accordance with GAAP.

55 Although the Financial Markets Authority has recently published draft guidance for public consultation on the disclosure of non-GAAP financial information, the increasing use of this practice indicates that many for-profit reporting entities would seek to inflate their profits in the GAAP financial statements at the back of the annual report, given the opportunity. However, the risks are reasonably low because there would be three important constraints if the prohibition on the override were to be repealed:

a. The override test in NZ IAS 1 is very strict. The override may only be exercised "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";

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

c. The company 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.

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

The potential benefits to users

57 IFRSs are intended for worldwide use and cannot be written to fully anticipate the needs of every country. There has been one example since New Zealand adopted IFRS in 2007 where the override could well have been used absent the prohibition. The IFRS relating to taxation (IAS 12) became incompatible with the New Zealand 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 users of the financial statements and caused widespread concern in the accounting profession.

58 The International Accounting Standards Board (IASB) resolved the problem in part in early 2011 by modifying the rule in IAS 12. However, New Zealand standards-setters will not always have the influence 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.

Application of the override to public benefit entities

59 The override prohibition in the FR Act applies to all reporting entities including public and private sector not-for-profit reporting entities (collectively referred to as public benefit entities or PBEs). Although IFRS currently apply to PBE reporting entities, the XRB has decided that International Public Sector Accounting Standards (IPSAS) will be the basis for PBE financial reporting in future. IPSAS 1 uses the same "extremely rare circumstances" override test that appears in IAS 1. Therefore, it is very likely that the XRB would take an equally strict approach to the use of the override by PBEs.

International practice and trans-Tasman harmonisation

60 Most of the 100-plus countries that have adopted IFRS or permit IFRS to be used allow the override rule in IAS1 to apply. China, Chinese Taipei, Australia and New Zealand are among the few that do not.

61 A potential downside of repealing the statutory prohibition on the override would be to de-harmonise New Zealand and Australian law. However, this concern is more perceived than real. The rare circumstances in which the override might apply are mostly likely to arise due to an atypical law or regulation in New Zealand. There would not be a trans-Tasman harmonisation issue unless Australia had the same atypical arrangement.

Conclusions on the true and fair override

62 I am recommending that the prohibition be repealed for the following reasons:

a. Users' needs should consistently be the most important driver of financial reporting policy. The deferred tax liability example demonstrates that allowing an override can, at times, be of benefit to users;

b. The risk of misuse of the override to the detriment of users' interests is reasonably low; and

c. The prohibition against the true and fair override is inconsistent with broader financial reporting policy because it is the only part of GAAP that is specifically prohibited by legislation.

K: Non-financial requirements in financial reporting standards

Background

63 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, particularly service performance standards. I am recommending that the Act be clarified by explicitly stating that the XRB has the power to make standards covering related non-financial matters (e.g. service performance standards).

Other changes

64 In September 2011 Cabinet authorised the Minister of Commerce to make changes consistent with the policy framework outlined in the paper under EGI (11)178 on any issues that arise during the drafting process [EGI Min (11) 19/1, paragraph 57 refers]. I have instructed officials to make the following changes:

a. To clarify and improve the law by modernising and standardising financial reporting language across the statute base as follows:

   i. Replacing diverse provisions relating to keeping proper accounting records with a standard modern wording;

   ii. Making it clear that all reporting entities must prepare financial statements in accordance with GAAP (i.e. the accounting standards issued by the XRB). This change is needed to deal with older Acts that make no reference to GAAP (because it was not legislatively defined until 1993). It is likely that most if not all of those entities already understand that they are expected to comply with GAAP;

   iii. Replacing diverse provisions relating auditors' qualifications with a standard provision modelled on the qualification and disqualification provisions in the Companies Act 1993. These provisions will apply to all audits of general purpose financial reports other than those prepared by:

      1. Public entities – Those audits will continue to be subject to the Public Audit Act 2001; and

      2. Financial markets conduct reporting entities – Those audits will need to be carried out by auditors and auditing firms licensed under the Auditor Regulation Act 2011;

   iv. Consistently requiring audits of general purpose financial reports to be carried out in accordance with the auditing and assurance standards issued by the XRB. This change will clarify current practice for most if not all of these audits because NZICA's rules require its members to carry out all audits of general purpose financial reports in accordance with the standards issued by the XRB;

   v. Having a standard provision relating to auditor access to information, with a maximum fine of $10,000 for failure to comply with those access provisions. At present some Acts include such provisions while others do not; and

   vi. Repealing provisions that duplicate or conflict with the standards issued by the XRB. The main changes relate to Acts that:

      1. Prescribe the contents of the financial statements in ways that are inconsistent with financial reporting standards;

      2. Use outdated language;

      3. Prescribe the contents of the audit certificate in ways that are inconsistent with auditing and assurance standards and modern audit practice;

b. To modernise the definition of GAAP. The current definition has two limbs. First, preparers must comply with applicable financial reporting standards. Second, preparers must use accounting policies which have authoritative support within the accounting profession in relation to matters for which no provision is made in accounting standards. This definition was written about 20 years ago when the standards were far from comprehensive. That is no longer the case. They now deal with almost every conceivable situation and the "authoritative support" limb is now redundant. In addition, international standards setters issue conceptual frameworks that provide guidance on how to deal with the rare cases not covered by accounting standards. I have therefore decided:

   i. To retain the requirement to comply with applicable financial reporting standards;

   ii. To replace the "authoritative support within the profession" test with a power for the XRB to issue "authoritative notices". This change will permit the XRB to issue conceptual frameworks and other high level guidance material; and

   iii. To repeal a power permitting the XRB to issue determinations. This power is no longer needed.

c. To increase the flexibility for the Registrar of Companies to accept financial statements prepared in accordance with GAAPs other than NZ GAAP. The Registrar can accept financial statements prepared in accordance with an overseas GAAP that is "substantially the same" as New Zealand's. I have decided to change the test to "substantially equivalent". This will allow the Registrar to accept financial statements prepared in accordance with an overseas GAAP that is not IFRS-based but is recognised as being high quality (e.g. United States GAAP); and

d. To repeal FR Act provisions that prescribe the manner in which a reporting entity can elect to early-adopt a standard if early adoption of that standard is permitted by the XRB. It is unnecessary to prescribe the election process. It is also likely that the process is not being consistently applied.

Consultation

65 Comments were sought on this paper, the RIS and the Bill from the Department of Building and Housing, Department of Conservation, Department of Internal Affairs, Inland Revenue Department, Ministry of Health, Ministry of Justice, New Zealand Customs Service, New Zealand Defence Force, Te Puni Kokiri, Treasury, Charities Commission, External Reporting Board, Financial Markets Authority, Māori Trustee and Office of the Auditor-General. The Department of the Prime Minister and Cabinet was informed.

66 Comments were sought on the Bill in relation to the tidying-up changes in recommendation 27 from:

a. The Ministries for Culture and Heritage, Defence, Education, Environment, Primary Industries, Science and Innovation, and Transport; and

b. Land Information New Zealand, Reserve Bank of New Zealand and State Services Commission.

Regulatory Impact Analysis

67 A regulatory impact statement is attached in relation to the secondary policy change proposals. A regulatory impact statement was prepared in relation to the other contents of the Bill when policy decisions were sought in September 2011.

Quality of the Impact Analysis

68 The MED Regulatory Impact Analysis Review Panel has reviewed the RIS prepared by MED and associated supporting material, and considers that the information and analysis summarised in the RIS meets the quality assurance criteria.

Consistency with Government Statement on Regulation

69 I have considered the analysis and advice of my officials, as summarised in the attached RIS and I am satisfied that, aside from the risks, uncertainties and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:

- Are required in the public interest;
- Will deliver the highest net benefits of the practical options available, and
- Are consistent with our commitments in the Government Statement on Regulation.

Compliance

70 The Bill complies with all of the following:

- The principles of the Treaty of Waitangi;
- The rights and freedoms contained in the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993;
- The principles and guidelines set out in the Privacy Act 1993;
- Relevant international standards and guidelines; and
- The LAC Guidelines: Guidelines on Process and Content of Legislation, a publication by the Legislation Advisory Committee.

Fiscal Implications

71 There are no fiscal implications.

Creating new agencies or amending law relating to existing agencies

72 The Bill will not create any new agencies.

73 It proposes new powers for the XRB to make financial reporting standards for registered charities. The largest 5% of charities will be required to comply with standards that will also apply to most public sector entities. Therefore, there is no material additional commitment for the XRB in relation to large charities.

74 The XRB is in the process of developing two simple format reporting standards (one accruals-based, the other cash-based) for the remaining 95% of registered charities. There will be a significant time commitment to complete the simple format standards in 2012 and 2013. Very little time will be required to maintain them once they are issued.

75 The Financial Markets Authority will be responsible for enforcing the financial reporting-related offence provisions for financial markets conduct reporting entities. The Department of Internal Affairs will be responsible for enforcing the offence provision under the Charities Act for knowingly failing to comply with accounting standards.

Binding on the Crown

76 The Bill states that the Act binds the Crown.

Associated regulations

77 Regulations will be required to bring most parts of the Bill and the SOP to the FMC Bill into force. In addition it is likely that there will need to be regulations relating to the transition for the financial reporting provisions as they relate to FMC reporting entities with the aim of bringing the financial reporting provisions and the rest of the FMC Bill into force simultaneously.

78 The regulations bringing the Bill into force should be short and simple. The regulations relating to the transition should be short but there may be some complexities.

Deemed regulations

79 The Regulations (Disallowance) Act 1989 applies to all financial reporting, auditing and assurance standards and other standards-related determinations issued by the XRB under the Financial Reporting Act 1993. The Bill provides for the continuation of this approach under the replacement Financial Reporting Act.

The name of the Bill and the Parliamentary stages

80 The Financial Reporting Amendment Bill holds a priority 4 on the 2012 legislative programme (to be referred to a select committee in 2012). As it eventuates, the changes are extensive and a rewrite of the Financial Reporting Act 1993 was required. Accordingly, the name of the Bill does not include the word "Amendment".

81 I propose that the FR Bill be introduced into the House in July 2012 and referred to the Commerce Select Committee. The Bill should be passed by July 2013. This timing would allow the Bill to come into force on the same date as the Financial Markets Conduct Bill.

Commencement of the Act

Bringing the issuer-related provisions into force

82 The intention is that most of the FR Act would come into force on the same date as the FMC Act, which is anticipated to start to come into force in 2014. This approach will provide for a seamless transition for FMC reporting entities. They will move from having to publish audited financial statements under the Financial Reporting Act and other Acts (e.g. the Building Societies Act) to having the same set of obligations under the FMC Act.

83 It is possible that the commencement timing may have to be changed, particularly if there were to be a significant delay in the passage of either Act or the making of regulations. The FMC Act in particular requires a significant amount of regulations before it can fully come into force. There are contingency plans for these and other possibilities.

Bringing the medium and small companies reforms into force

84 There is an imperative to replace GPFR for medium and small companies with SPFR for tax purposes at an early date because of the associated compliance cost reductions, which are estimated by officials to be about $90 million a year. The SPFR regime will not be able to be introduced until the Tax Administration Act has been amended. I understand that the intention is to include those changes in the Bill that is referred to as the *Taxation (November) Bill* in the 2012 Legislation Programme. It has a Category 4 priority: to be referred to a select committee in 2012.

85 If the FR Bill and the Taxation (November) Bill are both enacted by mid-2013 then it should be possible to bring the tax SPFR system into force at the start of the 2014/15 tax year. The GPFR reporting requirements could cease at about the same time. Any delay in the enactment of either Bill beyond mid-2013 is likely to delay implementation for 12 months, given the need to time the changes to fit with the tax year.

Bringing the accounting standards for registered charities into force

86 The power for the XRB to issue standards for registered charities would come into force by Order-in-Council sometime after the enactment of the Bill. The XRB has stated that it proposes to apply standards to registered charities for financial years beginning on or after 1 April 2015.

87 The lead-in time is needed to give charities time to modify their accounting record keeping systems. Accounting standards require reporting entities to include comparative information for the previous financial year so the information collection would need to start in 2014.

Bringing all other provisions into force

88 The intention is to bring all other provisions into force on the same date that the issuer-related changes come into force. This approach will avoid unnecessary complexity.

Publicity

89 I propose to release a media statement when the Bill is introduced.

Recommendations

I recommend that the Committee:

Companies and other for-profit reporting entities

1 **Rescind** the following decisions made in September 2011 [EGI Min (11) 19/1, paragraphs 5, 7, 20.2 and 22.1]:

1.1 Large companies and other large for-profit entities will be required to prepare general purpose financial reports (GPFR) and have them audited by a licensed auditor, chartered accountant or approved overseas person [paragraph 5]

1.2 To replace the current requirement on all non-large companies to prepare GPFR with the following:

1.2.1 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 of shareholders to opt out **of assurance or preparation;**

1.2.2 for companies with fewer than 10 shareholders, a default of no GPFR preparation, but with the ability for shareholders to opt in to preparation and assurance [paragraph 7];

1.3 Add a requirement [for other classes of for-profit entities] to have an audit conducted by a licensed auditor, chartered accountant or approved overseas person [paragraph 20.2];

1.4 To require large partnerships to prepare [general purpose financial reports], have them audited by a licensed auditor, chartered accountant or approved overseas person, and distribute them to all partners [paragraph 22.1];

2 **Agree** to replace the decisions listed in recommendation 1 with the following:

2.1 Large companies and other large for-profit entities will be required to prepare GPFR;

2.2 The default for large companies, partnerships, limited partnerships and industrial and provident societies that are not issuers will be to have their GPFR audited but that they may opt out if owners representing 95% or more of the voting rights agree, providing that the entity is not required to lodge or otherwise publish its financial statements;

2.3 Replace the current requirement on all non-large companies that are not financial markets conduct reporting entities to prepare an annual report that includes GPFR with the following:

2.3.1 For companies with 10 or more shareholders, a default of annual report and GPFR preparation, and assurance by a chartered accountant or licensed auditor, but with the ability of shareholders to opt out of assurance, GPFR preparation and annual report preparation;

2.3.2 For companies with fewer than 10 shareholders, a default of no annual report or GPFR preparation, but with the ability for shareholders to opt in to annual report preparation, GPFR preparation and assurance;

2.4 Require large partnerships to prepare general purpose financial reports and distribute them to all partners;

Financial markets conduct reporting entities

3 **Agree** that the following entities be reporting entities under the Financial Markets Conduct Act (FMC reporting entities):

3.1 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;

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

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

4 **Note** that the Financial Markets Authority will have the power to exempt entities or classes of entities from being FMC reporting entities under the FMC Act;

5 **Agree** that the financial reporting requirements for all reporting entities that will be subject to the Financial Markets Conduct Act be consolidated in that Act;

6 **Agree** to exempt a company from being an FMC reporting entity if:

6.1 the company is only an FMC reporting entity because of the issue of voting equity securities under a regulated offer; and

6.2 there are fewer than 50 shareholders or share parcels in respect of voting equity securities;

7 **Agree** to the following offence provisions for failure by a financial markets conduct reporting entity to comply with an applicable financial reporting standard:

7.1 For a knowing failure to comply:

7.1.1 Imprisonment for a term not exceeding 5 years, a fine not exceeding $500,000 or both in the case of an individual;

7.1.2 A fine not exceeding $2.5 million in any other case;

7.2 For any other failure to comply, a civil penalty not exceeding the greatest of the consideration for the relevant transaction, three times the amount of the gain made or loss avoided, and $1 million in the case of an individual or $5 million in any other case;

Registered charities

8 **Agree** that it will be an offence for registered charities and their officers to knowingly not comply with an applicable financial reporting standard, with the maximum fine being $50,000;

Other offence provisions

9 **Note** that the maximum fines for financial reporting entities from Act to Act varies considerably, with many maxima being very outdated;

10 **Agree**, in relation to reporting entities that are not FMC reporting entities, companies, registered charities or public entities, to standardise the offence provisions, with the maximum fine being $50,000;

Small reporting entities

11 **Agree** to permit the following reporting entities to prepare on a cash basis, as an alternative to accrual reporting, if their annual payments are less than $40,000:

11.1 Agricultural and pastoral societies;

11.2 Cemetery boards;

11.3 Friendly societies;

11.4 Māori incorporations;

11.5 Māori Purposes Fund Account;

11.6 Ngāti Whakaue Education Endowment Trust Board;

11.7 Provincial patriotic councils;

11.8 Reserves boards;

12 **Agree** to a regulation-making power to provide for the dollar amount in recommendation 11 to be increased from time to time;

Incorporated societies, Māori land trusts and friendly societies

13 **Note** that it would be appropriate to wait until the outcome of the Law Commission's review of incorporated societies before agreeing to financial reporting requirements for incorporated societies and other classes of entity that are broadly similar from a financial reporting perspective;

14 **Rescind** the following decisions made in September 2011 in relation to Māori Land Trusts [EGI Min (11) 19/1, paragraphs 51-54]:

14.1 **Noted** that the Māori Land Court is responsible for setting the financial reporting requirements for Māori land trusts;

14.2 **Agreed** that, with the exception of trusts with annual operating expenditure of less than $15,000, default requirements be introduced consistent with those proposed for incorporated societies;

14.3 **Agreed** that the default reporting requirements for trusts with annual operating expenditure of less than $15,000 be to prepare simple format cash accounting reports, but with no requirement to distribute them to owners;

14.4 **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

15 **Rescind** the following decision made in September 2011 in relation to friendly societies that do not provide insurance services [EGI Min (11) 19/1, paragraph 41]:

15.1 **Agreed** that the financial reporting obligations for friendly societies that do not provide insurance services be consistent with those for incorporated societies;

16 **Agree** to repeal the requirement for friendly societies with operating expenditure of less than $40,000 have an audit carried out providing that they are not issuers or insurers;

Retirement villages

17 **Rescind** the following decision made in September 2011 in relation to retirement villages [EGI Min (11) 19/1, paragraph 46]:

17.1 **Agreed** to require villages that are large, but not issuers in a securities law sense, to file audited [general purpose financial reports], and that the audit be conducted by a licensed auditor, chartered accountant or overseas-qualified person;

18 **Agree** that all retirement villages be required to lodge audited general purpose financial reports with the Registrar of Retirement Villages, and that the audit be carried out by a licensed auditor, chartered accountant or overseas-qualified person;

External Reporting Board's powers

19 **Agree** to repeal the prohibition on the true and fair override;

20 **Agree** that the Bill explicitly allow the External Reporting Board to issue service performance standards;

21 **Agree** to include a power for Orders-in-Council to be made authorising the External Reporting Board to make standards relating to other non-financial matters if the responsible Minister is satisfied that this would be desirable;

Minor and technical changes

22 **Note** that Cabinet authorised the Minister of Commerce to make changes, consistent with the policy framework outlined in the paper under EGI (11)178, on any issues that arise during the drafting process [EGI Min (11) 19/1, paragraph 57 refers];

23 **Note** that I have authorised that the following additions and changes be made:

23.1 To standardise and modernise the requirements in numerous Acts relating to such matters as keeping accounting records, preparing financial statements in accordance with generally accepted accounting practice, auditor qualifications, audits being carried out in accordance with standards issued by the External Reporting Board and auditors' access to information;

23.2 To modernise the definition of generally accepted accounting practice and consistently apply it to reporting entities;

23.3 To provide the Registrar of Companies with broader scope to accept financial statements filed by overseas companies that have been prepared in accordance with GAAPs other than NZ GAAP;

23.4 To remove the provisions that prescribe the process the reporting entities must apply to adopt a standard in financial years before the standard becomes mandatory;

The legislative process

24 **Note** that the Financial Reporting Bill holds a priority 4 on the 2012 legislation programme: to be referred to a select committee in 2012;

25 **Note** that the Bill will amend the Building Societies Act 1965, Charities Act 2005, Companies Act 1993, Friendly Societies and Credit Unions Act 1982, Gambling Act 2003, Industrial and Provident Societies Act 1908, Income Tax Act 2007, Insurance (Prudential Supervision) Act 2010, Limited Partnerships Act 2008, Partnership Act 1908, Retirement Villages Act 2003 and Te Ture Whenua Māori Act 1993;

26 Note that a supplementary order paper to the Bill sets out amendments to the FMC Act that will establish financial reporting obligations of FMC reporting entities and that these amendments will be incorporated into the Bill once the FMC Act has been enacted;

27 **Note** that the Bill will substantively amend the following Acts to standardise financial reporting language or otherwise make financial reporting fully consistent with the financial reporting framework: Agricultural and Pastoral Societies Act 1908, Armed Forces Canteens Act 1948, Building Research Levy Act 1969, Burial and Cremation Act 1964, Cadastral Survey Act 2002, Community Trusts Act 1999, Education Act 1989, Engineering Associates Act 1961, Export Guarantee Act 1964, Land Drainage Act 1908, Māori Community Development Act 1962, Māori Purposes Fund Act 1934-35, New Zealand Council for Educational Research Act 1972, New Zealand Horticulture Export Authority Act 1987, New Zealand Māori Arts and Crafts Institute Act 1963, Ngarimu VC and 28th (Māori) Battalion Memorial Scholarship Fund Act 1945, Ngati Tuwharetoa, Raukawa, and Te Arawa River Iwi Waikato Act 2010, Pacific Islands Polynesian Education Foundation Act 1972, Patriotic and Canteen Funds Act 1947, Reserves and Other Lands Disposal Act 1995, Reserves Act 1977, Taranaki Scholarships Trust Board Act 1957, Taratahi Agricultural Training Centre (Wairarapa) Act 1969, and Winston Churchill Memorial Trust Act 1965;

28 **Note** that the Bill will consequentially amend numerous other Acts;

29 **Approve** the introduction of the Financial Reporting Bill and the release of the SOP, subject to approval by the government caucus;

30 **Agree** that the Financial Reporting Bill be introduced and the SOP released in July 2012;

31 **Agree** that the Government propose that the Financial Reporting Bill be:

31.1 Referred to the Commerce Select Committee; and

31.2 Enacted by June 2013;

Publicity

32 **Note** that the Ministry of Economic Development will publish a copy of this paper on its website.

Hon Craig Foss
Minister of Commerce
17/7/12