

Regulatory Impact Statement

THE REVIEW OF THE FINANCIAL REPORTING FRAMEWORK

AGENCY DISCLOSURE STATEMENT

This Regulatory Impact Statement has been prepared by the Ministry of Economic Development. It covers the issues addressed in both the primary and secondary issues Cabinet papers.

It provides an analysis of options to make financial reporting law consistent with the principles and indicators of financial reporting. The main aim of the review is to find an appropriate balance between the costs of reporting and the benefits that users obtain from financial reports to assist users to make economic decisions, to promote accountability and transparency or both.

There have been three significant constraints in identifying the costs and benefits of the changes proposed in this RIS.

First, the External Reporting Board (XRB) is responsible for deciding which set of standards each class of reporting entity will need to comply with. The preparation costs vary markedly from one tier to another. We have managed this risk by informally obtaining information from the XRB about which tier they are likely to place each class of entity if the Government was to agree to the proposals appearing in this RIS.

Secondly, while there are some very useful statistics about the numbers of entities in some classes or sub-classes, there is very limited information for others. We have partially managed that risk by talking to individuals who can provide reasonable estimates of likely numbers. It has not been possible to obtain reliable estimates in some cases.

Thirdly, some of the costs and benefits are very difficult to quantify. We have estimated many of the compliance cost reductions and increases. However, it has not been possible to quantify the economic decision-making and transparency costs and benefits. For example, we know in a general sense that investors and their professional advisers use financial reports to contribute to share buy, sell or hold decisions and advice. However, we do not know how much worse the decisions and advice would be absent financial reports. Even if we did, it would be very challenging to attempt to quantify the resulting harm. Likewise, there is broad societal acceptance that financial reporting is an indispensable element of government entity accountability to taxpayers and ratepayers, but attempting to estimate the benefits in dollar terms is more likely to mislead ministers than help them make an informed decision.

The RIS includes estimates of compliance cost savings in relation to small and medium companies. It has been difficult to estimate the savings for two reasons. First, we do not know how many of the 460,000-odd companies are small and medium-sized. This matters because medium companies will move from moderately complex reporting to simple format reporting whereas small companies will move from one type of simple format reporting to another. We consider that our assumption of 10,000 medium companies is conservative. Secondly, Inland Revenue are yet to design the new form of simple format reporting, so we do not know how much the saving will be for each small company.

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

Geoff Connor
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28 June 2011

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DEFINITIONS

- 1 Definitions of the following accounting terms, which are used throughout this RIS, appear in Appendix One.
 - a Generally accepted accounting practice (GAAP)
 - b General purpose financial reporting/reports (GPFR)
 - c Special purpose financial reporting/reports (SPFR)
 - d Accrual accounting and cash-in/cash-out accounting
 - e Reasonable assurance (i.e. audit) and limited assurance (i.e. review)

BACKGROUND

- 2 Financial reporting law addresses the following matters:
 - a Whether an entity is required to prepare an annual GPFR;
 - b The set of standards that will need to be complied with by each class of reporting entity;
 - c If so, whether the entity is also required to:
 - i Have an assurance engagement completed. If so, the law also needs:
 - To state whether an audit will be required or whether a review would be acceptable; and
 - To identify any restrictions on who may carry out the engagement;
 - ii Distribute the report to the entity's owners or members; and/or
 - iii Make the report available to the general public (e.g. by way of a public register operated by a government department, statutory officer or Crown entity, or having them tabled in Parliament).

- 3 Parliament will decide which entities are required to prepare financial statements and, if so, whether, assurance, distribution and publication are required. Under the Financial Reporting Amendment Act 2011, the XRB will recommend the qualifying criteria for each tier of reporting to the Responsible Minister. The Minister may refer the proposals back to the XRB for further consideration in limited circumstances. Otherwise the Minister must accept the proposals. Thus, in a real sense, the XRB will have the predominant say on the qualifying criteria for each tier of reporting.
- 4 The XRB will be responsible for setting the standards for each tier of reporting.

OBJECTIVES

- 5 The reason for imposing statutory financial reporting obligations is to provide information to external users who have a need for an entity's financial statements but are unable to demand them. Decisions about who should have to report and, if so, what they should report predominantly involve trade-offs between the benefits of transparency and accountability to users and the compliance costs associated with financial reporting. The overall objective is to obtain an appropriate balance between the benefits and costs.

The indicators of financial reporting

- 6 There are three "indicators" that there are external users who are unable to demand the financial information they need for decision-making or accountability reasons. If one or more of the indicators is met, then there is a rebuttable presumption that financial reporting of some sort or another is needed, depending on which indicator applies. The indicators are:
 - a **Public accountability:** Is the entity effectively owned by the public and/or is it funded directly by the public? If so, it should be required to prepare and publish assured GPFR, unless there are outweighing compliance costs.
 - b **Economic significance:** Is the entity large? If so, its failure could have significant economic and social impacts. It should be required to prepare and publish assured GPFR, unless there are outweighing commercial confidentiality and/or privacy-related costs. Where publication is not justified, the entity should be required to prepare assured GPFR and distribute them to the entity's owners or members.
 - c **Separation:** Are the managers and the owners or members of the entity the same or different people? If there is a significant degree of separation, the default position should be preparation, assurance and distribution, but not publication. However, the owners or members should be able to "opt out" of assurance or preparation. If there is no significant degree of separation, there should be no financial reporting obligations but the owners or members should be able to opt in to preparation, assurance and distribution.

- 7 The three indicators should be considered in the order they appear above. Economic significance needs to only be considered if the entity is not publicly accountable. Separation needs to only be considered if the two other indicators do not apply. This framework appears in flowchart form in Appendix Two.
- 8 Some submitters (notably Deloitte and Pricewaterhouse Coopers) suggested a second objective for financial reporting to the effect that financial reporting assists in the efficient operation of the economy even when they are not published. They also promote confidence in business and public benefit entity activities and enable compliance with related statutory obligations, such as the solvency test in the Companies Act.
- 9 The main implication of adopting a public confidence/financial discipline indicator is that all entities would, at minimum, be required to prepare simple format financial statements in accordance with standards made by the XRB. It is not clear that the associated large compliance costs would be outweighed by the benefits to the public. This is particularly so for for-profit entities because they need to file tax returns. It is also well known that many small companies do not use the current simple format reports for decision-making or accountability purposes. Even if the public does obtain some confidence from such requirements, then it may be unwarranted in many cases.
- 10 To conclude, we consider that the addition of a public confidence indicator would clearly fail the “reasonable, required and robust” test appearing in the Government’s statement on regulation dated 11 August 2009.

STATUS QUO AND PROBLEM DEFINITION

- 11 A number of statutes impose financial reporting requirements of some sort or another on defined entities and classes of entities. The most significant are the Financial Reporting Act 1993, the Securities Act 1978, the Companies Act 1993, the Public Finance Act 1989, the Crown Entities Act 2004, the Public Audit Act 2001 and the Charities Act 2005.
- 12 The main problem with the status quo is that some entities’ reporting obligations do not fit with the indicators of financial reporting. In some cases the reporting obligations are excessive and in other cases they are insufficient.
- 13 An entity that has excessive reporting obligations is probably incurring unnecessary compliance costs. For example, an entity that is unnecessarily required to prepare GPFR will probably be disclosing information that is of no value to any users. More disclosures mean more ledger accounts, every one of which needs to be reconciled. The additional disclosures can consequentially increase the complexity and cost of an assurance engagement. This is also the case for reporting entities that have no external users and only need financial information for internal governance purposes.
- 14 The problem is the reverse in relation to entities whose reporting obligations fall short of the requirements that would be suggested by the indicators. Users are not obtaining the information they need in these circumstances.

REGULATORY IMPACT ANALYSIS

The benefits and costs of financial reporting

- 15 The main benefits of financial reporting law are to provide information that can be used:
- a For economic decision making – This benefit arises when users rely on GPFR to decide whether to transact with the reporting entity. For example, financial statements can be used to contribute to decisions about whether to buy, sell or hold shares; and
 - b To promote accountability by the entity – This benefit arises when users rely on GPFR to determine whether the reporting entity has been using or managing the users' money effectively and efficiently. For example, a reason that public sector entities are required to publish audited financial statements is to promote accountability to taxpayers and ratepayers.
- 16 The costs comprise some or all of the following, depending on the extent of the reporting obligations:
- a **Preparation** – The major preparation costs relate to maintaining and reconciling the ledger accounts that need to be kept for each disclosure and compiling the information in accordance with the presentation requirements included in financial reporting standards. Those costs vary considerably depending on the requirements of the set of standards that apply to the entity. There are three tiers at present ranging from complex to simple format reporting. Preparers in the highest tier of reporting also need to keep up to date with the frequent additions and alterations to International Financial Reporting Standards. The net preparation cost is:
 - i In the case of an entity that does or would produce an alternative SPFR if it did not prepare GPFR, the difference between the costs of preparing the two different sets of financial statements; or
 - ii In the case of an entity that would not produce an alternative SPFR, the gross preparation costs. Very few entities would fall into this category. Most entities prepare SPFR for tax, banking and/or governance reasons.

- b **Assurance** – The main factors that determine the gross cost of an audit are the size of the entity, the range and nature of the activities it carries out, and the complexity of its transactions. Assurance costs include a fixed and a variable cost element. This means that the cost of assurance engagement tends to be a smaller proportion of total costs the larger the entity. For example, Telecom Corporation Ltd's audit fee in its latest financial year was \$4.16 million, which was less than 0.1% of its total operating expenses. By contrast the audit fee for Kirkcaldie & Stains Ltd (which is small by listed company standards) was \$73,000 which is about 0.2% of its total expenses. For very small entities, such as micro charities, an audit can be more than 5% of total operating expenditure. A review engagement tends to cost from a half to two-thirds of the cost of an audit. The net cost of imposing a statutory audit obligation is:
- i The cost of the audit if the entity is obliged to have an audit carried out but would not otherwise have an assurance engagement completed;
 - ii The difference between the cost of an audit and a review if the entity is obliged to have an audit carried out but would otherwise have a review completed;
 - iii The cost of the review if the entity is obliged to have a review carried out but would not otherwise have had an assurance engagement completed; or
 - iv Nil for an entity that would have had an audit (or review) carried out even if the statutory obligation to have an audit (or review) did not exist.
- c **Distribution** – In most cases, the cost of distributing GPFR to owners or members is very small compared with the benefits and other costs of financial reporting. This has become increasingly so due to the big increase in the use of electronic distribution in recent years; and
- d **Publication** – The direct publication cost in itself is usually very small compared with the benefits and other costs. However, the publication cost may be significant if a report contains commercially confidential information. This risk tends to be low because most firms sell more than a single product and financial reports do not provide information about marginal costs. There can be privacy costs for large closely-held businesses.

- 17 Many of the benefits and costs broadly outlined above will arise from the decisions that the Government will make in relation to the matters addressed in this RIS. However, other costs and benefits will depend on decisions that the XRB make. The XRB will make two main decisions. The first will be to recommend tiers of reporting to the responsible Minister. It will have a statutory obligation to have regard to the advantages and disadvantages of placing different classes of entities within different tiers. The second set relates to the benefits/costs that users obtain by requiring more/fewer disclosures in financial reports and the additional costs/benefits for preparers associated with the changes.
- 18 The overall costs and benefits will also be affected by the decisions yet to be made by Inland Revenue in relation to special purpose reporting for tax purposes, as a replacement for the current reporting required of small and medium-sized companies under the FRA.
- 19 A more intangible cost is that statutory financial reporting obligations can provide unwarranted or excessive public confidence. This is particularly true in relation to auditing. Scholarly articles on the audit expectation gap over the last four decades consistently demonstrate that company directors and financial statement users consider that an audit provides much higher and broader levels of assurance than is actually the case.

Options

- 20 There are two options in relation to all categories of entity; either set reporting obligations that are fully consistent with the indicators, or don't. Departure from the indicators can be justified if there are other costs and benefits in relation to a class of entity that have not been identified in Paragraphs 15 and 16 above.

THE PRIMARY ISSUES PAPER: ANALYSIS BY ENTITY TYPE

Table 1: Public sector entities

Indicator	All public sector entities are publicly accountable. Taxpayers and ratepayers effectively own all public sector entities. They also provide nearly all of the funding for most public sector entities.
Status quo	All public sector entities must prepare GPFR and have them audited. Most public sector entities must make them available publicly in one way or another.
Proposal	Retain the status quo.
Costs and benefits	No change.
Other options considered	We have not been able to identify any other feasible options.

Table 2: Issuers, including deposit takers and fiduciaries

Indicator	Issuers are publicly accountable because they seek money from the public, or take deposits and/or hold money for wide groups of outsiders in a fiduciary capacity.
Status quo	Most issuers are required to publish audited GPFR. There is an exception for companies that do not have more than 25 members if they would be issuers by reason only of the allotment of equity securities.
Proposal	Retain the status quo. The exception for small companies should be retained because the costs of preparation in accordance with the New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) are disproportionately high compared to the benefits obtained from reporting.
Costs and benefits	No change.
Other options considered	It has been suggested to us that there is no need to have statutory financial reporting requirements because it is in all issuers' self-interest to prepare high quality financial statements and have them audited. We do not agree for two reasons. First, it may encourage fraudulent reporting. Secondly, having statutory reporting requirements are essential from a market credibility and confidence perspective.

Table 3: Large companies that are not overseas-incorporated or owned

Indicator	Economic significance.
Status quo	Preparation in accordance with NZ IFRS (if widely held) or Differential Reporting (if closely held) and distribution to owners. An auditor must be appointed unless the owners unanimously decide not to. If there is a group of companies, the preparation requirement applies to each company and the group as a whole.
Proposals	Retain the preparation and distribution requirements. Remove the requirement for parent entity financial statements for groups of companies. These proposals are consistent with the idea that there can be significant adverse impacts on a society when a large entity fails and that GPFR can contribute to reducing the risks of business failure.
Costs and benefits	There will be a compliance cost saving for groups that include two or more large companies that are not issuers. However, only a small number of groups would fall into this category and the amount saved per group will be relatively small. There will be no changes in costs or benefits for other large companies.
Other options considered	Consideration was also given to introducing a requirement to file with the Registrar of Companies, which would mean that they would appear on the public register. However, in 2010 the Minister of Commerce decided against such a change for commercial confidentiality and privacy reasons.

Table 4: Large companies that have 25% or more overseas ownership and large overseas companies that carry on business in New Zealand

Indicator	Economic significance
Status quo	As per table 3, but with a requirement to file audited financial statements with the Registrar of Companies.
Proposal	Retain the status quo. GPFR are important for creditors of this class of company because of the difficulties of pursuing directors and shareholders in other jurisdictions in the event that the company fails. Therefore, the filing requirement should be retained.
Costs and benefits	No change.
Other options considered	Consideration was given to removing the filing requirement but was rejected for the creditor protection reason.

Table 5: Medium and small companies that are widely held

Indicator	Separation.
Status quo	Preparation in accordance with Differential Reporting (medium) or the Financial Reporting Order (small) and distribution to owners. An auditor must be appointed unless the shareholders unanimously decide not to. There is widespread non-compliance with the auditor appointment requirements among small companies.
Proposal	A default of preparation, assurance and distribution but allow shareholders to opt out of assurance and preparation. There will be new SPFR obligations under the Tax Administration Act.
Costs and benefits	The costs and benefits are incorporated into the analysis in Table 6.
Other options considered	Consideration was given to retaining the status quo on the grounds that a preparation requirement may establish a minimum level of financial discipline to promote confidence in the healthy functioning of business. However, such confidence is provided through other means, particularly the requirement to file tax returns. NZICA is also planning to produce guidance material. In addition, many owners and managers of small companies do not put GPFR to any use. Therefore, if there is such public confidence then it may be misplaced.

Table 6: Medium and small companies that are closely held

Indicator	No indicators apply.
Status quo	See Table 5.
Proposal	A default of no GPFR requirements, but with (a) the ability of shareholders to opt in to preparation and, if so, assurance; and (b) new SPFR obligations under the Tax Administration Act.
Costs and benefits	The change from GPFR to tax SPFR for all medium and small companies incorporated in New Zealand will mean that compliance costs would fall for most of the 460,000 registered companies because they will have fewer disclosure requirements. This is particularly so for medium companies because they will move from moderately complex reporting under Differential Reporting to simple format reporting for tax purposes. If 10,000 medium companies saved an average of \$5,000, the compliance cost saving would be \$50 million a year. The compliance savings for small companies are less clear because the future tax SPFR requirements are unknown. If 400,000 small companies saved an average of \$100 the compliance cost saving would be an additional \$40 million a year. The compliance cost savings have the potential to increase because the number of companies is growing.
Other options considered	See Table 5.

Table 7: Non-large overseas companies that carry on business in New Zealand

Indicator	Separation if widely held. No indicators apply to closely held companies.
Status quo	All such companies are required to file audited financial statements with the Registrar of Companies.
Proposal	Make fully consistent with the proposals in Tables 5 & 6.
Costs and benefits	The compliance cost savings are likely to be relatively small. Only 1,575 overseas companies are registered and it is not known how many are not large.
Other options considered	Consideration was given to retaining the status quo. However, we are not aware of any reasons for treating small and medium overseas companies any differently to other small and medium companies.

Table 8: Small and medium trading trusts

Indicators	No indicators apply.
Status quo	Trading trusts have no financial reporting obligations.
Proposal	Retain the status quo.
Costs and benefits	No change.
Other options considered	We considered the option of having a no preparation default but with opt in being available. This would be consistent with the preferred proposal for other for-profit entities where no indicators apply. However, in practice such an approach is not needed because trustees can do this without having to rely on a statutory power.

Table 9: Small and medium limited partnerships

Indicators	Separation applies to all limited partnerships because, under the scheme of the Limited Partnerships Act, those who provide the capital (i.e. the limited partners) do not take part in management.
Status quo	The general partners must prepare GPFR and disclose them to the limited partners.
Proposal	Remove the preparation requirement. Although the separation indicator applies, limited partners are able to demand the financial information they need as a condition of providing the capital.
Costs and benefits	The total compliance cost saving is likely to be relatively small. The saving for each partnership would be small as there are only about 800 limited partnerships. However, the number is growing.
Other options considered	The only other option considered was to add an audit requirement (with opt out), in order to provide a reasonable assurance that the financial statements are free from material error. However, this option is inconsistent with the main conclusion that limited partners have the means to protect their own interests.

Table 10: Small and medium partnerships

Indicators	No indicators apply.
Status quo	There are no financial reporting obligations under the Partnership Act 1908.
Proposal	Retain the status quo.
Costs and benefits	No change.
Other options considered	We have not been able to identify any other feasible options.

Table 11: Large trading trusts, limited partnerships and partnerships

Indicators	Economic significance.
Status quo	The requirements vary depending on the form of entity, as described in Tables 8-10.
Proposal	Introduce a preparation, distribution and audit requirement.
Costs and benefits	The benefits and costs are likely to be relatively small because the proposed changes will affect a very small number of entities (probably considerably less than 50) and the cost per entity will be small. The benefits arise from reducing the risk of business failure if GAAP-compliant financial statements are prepared in accordance with a set of standards that senior management has no control over. It is reasonable to expect that governing bodies of large entities will incorporate GPFR into their decision making and governance accountability processes, with consequential improvements in some cases. The costs arise from any increases in preparation and assurance costs currently being incurred and what would need to be incurred. In practice this is likely to be small because the entities are likely to be (a) preparing financial statements similar to those that are required under the second tier of reporting; and (b) already having an audit completed.
Other options considered	Having no preparation requirements was considered. However, there is no reason to have different rules for different classes of large entities. The consequences for society of the failure of, say, a \$100 million a year entity will be much the same regardless of its legal form, all other things being equal.

Table 12: Sole traders

Indicators	No indicators apply.
Status quo	Sole traders have no financial reporting obligations.
Proposal	Retain the status quo.
Costs and benefits	No change.
Other options considered	Consideration was given to including sole traders in the title for Table 11. However, we doubt whether any sole trader business would come even close to being economically significant due to the personal liability risks.

Table 13: Entities registered under the Charities Act

Indicators	All 25,000-odd registered charities are publicly accountable because they accept donations from the public and/or earn revenue from assets that have been donated in the past.
Status quo	Registered charities are required to file financial statements as part of their annual return to the Charities Commission. However, there are no financial reporting standards to govern preparation. An unpublished study of 300 small and medium registered charities by Cordery and Patel (March 2011) notes that a wide variety of formats and bases are being used for financial statement compilation. They also found that many preparers are making fundamental mistakes. Sinclair's PhD thesis (2010) identifies similar problems with reports prepared by large registered charities. She also concluded that many large charities hide assets (e.g. in subsidiary trusts) with the aim of "looking poor" as they seek to gain more funding.
Proposal	(a) Empower the External Reporting Board (XRB) to make standards. (b) Create tiers of reporting. Depending on decisions yet to be made by the XRB, the tiers may be as outlined in Table 14.
Costs and benefits	Change (a) will establish a consistent basis for reporting. Change (b) is needed to recognise that the vast majority of registered charities are small or micro entities and should only have simple reporting obligations.
Other options considered	We considered the option of exempting micro-entities from reporting but were convinced by the Charities Commission and others that simple format cash reporting is a very important element of micro charity accountability and that having a single format would reduce compliance costs. We also tested alternative dollar thresholds for the tiers of reporting outlined in Table 14. We also considered the option of introducing a requirement for all registered charities above a certain size to have an assurance engagement completed. The main benefit of introducing such a change would be to improve the quality of reporting, which would consequentially improve decision making by users and increase accountability. However, it could also impose substantial compliance costs if the threshold for requiring assurance is set too low. We do not have enough information to determine an appropriate threshold at present. We will undertake more detailed and targeted NFP sector consultation before providing final advice to the Government on the assurance issue.

Table 14: Tiers for registered charities (tentative)

Annual operating expenditure	Preparation	Filing	Percentage of registered charities
<\$40,000	Simple format cash reporting	Yes	57%
\$40,000-\$2m	Simple format accrual reporting	Yes	39%
≥\$2 million	GAAP-compliant reporting	Yes	4%

Table 15: Charitable trusts that are not registered charities

Indicators	About 11,000 of the 20,000 or so charitable trusts are not registered charities. The 11,000 fall into three categories: (a) those that are no longer operating but remain on the register; (b) those that are essentially private; and (c) those that accept donations but consider that the tax and reputation benefits are not large enough to justify the compliance associated with registering with the Charities Commission. The separation indicator generally applies. Few, if any, would be economically significant. Category (c) trusts are publicly accountable.
Status quo	There are no financial reporting obligations and there is no requirement to file an annual return with the Registrar of Charitable Trusts.
Proposal	No changes are being recommended at this time. The Law Commission has released an issues paper which asks fundamental questions about whether there should continue to be two statutes for the incorporation of not-for-profits (i.e. the Incorporated Societies Act 1908 and the Charitable Trusts Act 1957) or just one. We consider that these fundamental issues should be addressed before decisions about their financial reporting obligations are made.
Costs and benefits	No change.
Other options considered	We considered whether to recommend changes consistent with the indicators of financial reporting now. However, we concluded that the benefits would be outweighed by the costs of entities possibly having to make two changes to their systems and processes in a relatively short timeframe.

Table 16: Incorporated societies that are not registered charities

Indicators	About 16,500 of the 23,000 incorporated societies are not registered charities. Only a small minority of the 16,500 are likely to be publicly accountable. Few if any are economically significant. The separation indicator applies to all incorporated societies.
Status quo	Simple balance sheet and income statement information must be included in a fill-in-the-box format in the annual return submitted to the Registrar of Incorporated Societies. There are no standards to govern what is prepared.
Proposal	For the reasons given in Table 15, no changes are being recommended at this time.
Costs and benefits	No change.
Other options considered	See Table 15.

Table 17: Industrial and provident societies

Indicators	The separation indicator applies to all 300-odd industrial and provident societies. One society is economically significant.
Status quo	File audited financial statements with the Registrar of Industrial and Provident Societies.
Proposal	(a) Retain the status quo for economically significant societies. (b) Retain the annual return requirement but remove the filing requirements for the remainder and apply the for-profit separation indicator defaults (see Table 30).
Costs and benefits	There would be a very small compliance cost reduction.
Other options considered	We have not been able to identify any other feasible options.

Table 18: Friendly societies

Indicators	Friendly societies that provide insurance services are publicly accountable. The separation indicator applies to all friendly societies.
Status quo	Friendly societies must file financial statements as part of their annual return to the Registrar. They must also have an audit completed if their receipts and payments both exceed \$50,000. The Registrar is required to examine the annual returns with a particular emphasis being placed upon the auditors' reports and solvency issues and report to Parliament.
Proposals	(a) Retain the filing requirements for societies that provide insurance services. (b) Remove the Registrar's monitoring function (it is no longer needed due to the enactment of the Insurance (Prudential Supervision) Act 2010). (c) For societies that do not provide insurance services, replace the current requirements with the default/opt-out proposals outlined in Table 31. (d) Consistent with the proposals in Table 14, increase the assurance threshold from \$50,000 to \$150,000.
Costs and benefits	There are 157 friendly societies. The compliance and monitoring cost savings will be relatively low.
Other options considered	We have not been able to identify any other feasible options.

Table 19: Credit unions

Indicators	All credit unions are publicly accountable because they accept deposits.
Status quo	Credit unions must file audited financial statements. The Registrar has a monitoring function as described for friendly societies.
Proposal	Retain the financial reporting requirements. Remove the monitoring function because credit unions are now prudentially regulated by the Reserve Bank.
Costs and benefits	The removal of the requirement for the Registrar to monitor and report on the 30 credit unions will lead to a very small cost reduction.
Other options considered	We have not been able to identify any other feasible options.

Table 20: Gaming machine societies

Indicators	There are two types of society: (a) Societies that operate gaming machines in commercial venues. They are publicly accountable; and (b) Club societies that operate machines almost exclusively in their own premises. They are not publicly accountable, but the separation indicator applies.
Status quo	All gaming societies are required to submit audited GAAP-compliant financial statements to the Department of Internal Affairs for regulatory purposes. Legal form determines whether a society is required to make the financial statements public. Those registered under the Friendly Societies and Credit Unions Act and the Incorporated Societies Act do. Charitable trusts and companies do not.
Proposal	Given that GAAP-compliant audited financial statements are required for regulatory purposes, the only financial reporting issue relates to publication, and distribution to members. Non-club societies and economically significant club societies should be required to publish. The other club societies should be required to distribute.
Costs and benefits	There are accountability and transparency benefits associated with publication and distribution. The compliance costs are close to zero.
Other options considered	We also considered whether DIA regulation was sufficient but concluded that public and member scrutiny of financial statements adds to gaming machine society accountability and transparency.

Table 21: Unincorporated societies

Indicators	Unincorporated societies that accept donations from the public are publicly accountable. A small number are economically significant (e.g. the Anglican Church) but the personal liability risks provide an incentive for larger societies to incorporate. The separation indicator is likely to apply to almost all unincorporated societies.
Status quo	Unincorporated societies only have financial reporting obligations if they are registered under the Charities Act (see Table 13).
Proposal	Retain the status quo. Although the separation indicator applies, the costs associated with any financial reporting obligations would be prohibitively expensive to enforce.
Costs and benefits	No change.
Other options considered	No other options were considered.

Table 22: Retirement villages

Indicators	Some retirement villages are publicly accountable because they are issuers. There may be some that are economically significant. The separation indicator applies to all villages.
Status quo	All retirement villages are required to file audited financial statements prepared in accordance with NZ IFRS.
Proposal	Retain the current requirements for villages that are issuers. Reduce the requirements for other villages in accordance with the tiers of reporting to be recommended by the XRB.
Costs and benefits	The requirement to prepare in accordance with NZ IFRS imposes unnecessary compliance in the form of (a) additional disclosures that are not useful, and (b) requirements for annual independent valuations of certain fixed assets. This can add \$10,000 or more in unnecessary costs for a retirement village. The total compliance cost saving would be \$1.25 million a year if it is assumed that 250 of the 331 registered villages were to save an average of \$5,000.
Other options considered	We have not been able to identify any other feasible options.

Table 23: Māori trust boards

Indicators	The separation indicator applies. Neither of the other indicators apply.
Status quo	Under proposals appearing in the Māori Purposes Bill, Māori trust boards will be required to distribute audited GPFR to the beneficiaries.
Proposal	Retain what is proposed in the Māori Purposes Bill.
Costs and benefits	No change.
Other options considered	We have not been able to identify any other feasible options.

Table 24: Māori reservations

Indicators	The separation indicator applies. Neither of the other indicators applies.
Status quo	There are no financial reporting obligations.
Proposal	Retain the status quo.
Costs and benefits	No change
Other options considered	The separation indicator would suggest that preparation, assurance and distribution should be introduced. However, Māori reservations are set aside over land that is culturally, spiritually or historically significant. They do not usually generate revenue and, if they do, the amounts are usually very low. Mandatory preparation of financial reports would seem to add little value to the obligation on trustees to maintain up-to-date records and accounts.

Table 25: Māori incorporations

Indicators	One or two of the 150 or so Māori incorporations may be economically significant. The separation indicator applies to all incorporations.
Status quo	Māori incorporations are required to file audited financial statements with the Māori Land Court Registrar. Registrars do not operate public registers and the information is only made available to shareholders.
Proposal	(a) Large Māori incorporations should prepare GPFR, have them audited and distribute them to the beneficial owners that appear on the register of owners held by the Maori Land Court. (b) Permit review as an alternative to audit for medium entities and remove the assurance obligations for small entities (See Table 14). (c) We are not proposing opt-out for non-large incorporations. There are, on average, 88 beneficial owners per title of Māori land. Many beneficial owners would not have the incentive to participate in an opt-out decision, given how insignificant their economic interest is likely to be.
Costs and benefits	The extra distribution costs for large Māori incorporations will be insignificant. The assurance related savings for non-large incorporations will also be small.
Other options considered	We also considered the opt-out option for non-large incorporations but rejected it for the reason indicated above.

Table 26: Māori land trusts

Indicators	A very small number of Māori land trusts may be economically significant. The separation indicator applies to all land trusts.
Status quo	The Māori Land Court has exclusive jurisdiction to set any financial reporting obligations.
Proposal	Introduce defaults but empower the Māori Land Court to vary those requirements to meet individual circumstances. The defaults would be: Large: GAAP preparation, audit and distribution to the known beneficial owners Medium: Simple format accrual preparation, review and distribution Small: Simple format accrual or cash preparation and distribution Micro: Simple format cash preparation.
Costs and benefits	The main benefit of the change will be to avoid the risks associated with ad hoc decision making.
Other options considered	Retention of the status quo was also considered.

THE SECONDARY ISSUES PAPER

INTRODUCTION

21 This section deals with the following miscellaneous issues that have arisen in relation to financial reporting:

- a Issues that are linked to matters addressed in the Primary Issues paper:
 - i Entities that fall into two or more categories of reporting
 - ii Opting up to a higher level of preparation or assurance
 - iii Opting out or into financial reporting
 - iv The definition of economic significance
 - v Changing monetary thresholds
- b Stand-alone issues:
 - i The definition of issuer
 - ii The preparation and filing deadline for companies

Table 27: Entities that fall into two or more categories of financial reporting

Issue	Entities can fall into two or more categories of reporting. For example, an entity may be both an issuer and economically significant.
Status quo	The higher or highest reporting obligation applies.
Proposal	Retain the status quo. An entity's reporting obligations should fit with all the indicators of financial reporting that apply.
Costs and benefits	None.
Other options considered	We have not been able to identify any other feasible options.

Table 28: Opting up to a higher level of preparation or assurance

Issue	The issue is whether entities that are not in the top tier of reporting should be able to opt-up to a higher level.
Status quo	Preparation opt-up is permitted. There is no status quo for assurance opt-up.
Proposal	Continue to permit opt-up to existing reporting entities and extend it to NFP entities in relation to both preparation and assurance.
Costs and benefits	No harm is done by permitting opt-up. An entity will only opt-up if it is in its economic interests to do so.
Other options considered	We have not been able to identify any other feasible options.

Table 29: Parent company financial statements

Issue	A reporting entity that has one or more subsidiaries should be required to prepare consolidated financial statements. Consolidated financial statements provide information about the overall scale of the company and the resources under its control. The issue is whether parent company financial statements should also be required.
Status quo	Consolidated and parent entity financial statements must be prepared.
Proposal	Remove the parent entity requirements and leave it to the XRB to determine what parent entity information, if any, will need to be disclosed in the notes to the consolidated financial statements.
Costs and benefits	There will be a reduction in compliance costs but we have been unable to estimate the amount. This will include benefits for companies that have reporting obligations in both NZ and Australia, because Australia made similar changes in 2010. The main potential cost is the loss of information that might be useful to users. We consider that those lost benefits are minor because parent company information is of little or no value to most users, particularly if the parent is a shell company. It can be of use to credit risk analysts if the parent conducts major trading and treasury operations. The XRB can take the benefits to this class of user into consideration in determining whether to require any parent entity disclosures in the notes to the consolidated financial statements.

Other options considered	We also considered the possibility of retaining the status quo. However, we concluded that the flexibility associated with the preferred approach based on users' needs is better than an indiscriminating requirement.
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Table 30: Opting out of or into financial reporting by for-profit entities (separation indicator only)

Issue	This issue links back to the discussion in Tables 5-7 about the default proxy for preparation/non-preparation and audit/non-audit. There also needs to be a rule to allow an entity to depart from its default position. The objective is to provide an appropriate balance between avoiding unnecessary compliance and protecting the interests of minority owners.
Status quo	The separation indicator is not being applied at present. However, companies can opt out of audit if shareholders unanimously agree. There is widespread non-compliance with this requirement.
Proposal	(a) Use 10 or more shareholders as a proxy for separation; (b) Opt-out would succeed if 95% of the voting shares cast on the motion supported the proposal; and (c) Opt-in would occur at the 5% support level.
Costs and benefits	The compliance costs are more likely to be proportionate and legal compliance rates are likely to increase because inertia effects will mostly favour the preferred small company position of not appointing an auditor.
Other options considered	We also considered whether opt-out could only succeed at the 100% level and opt-in would occur if any owner with voting rights required it. This option better protects the interests of minority owners. However, a single owner with a very small financial interest would be able to override the wishes of the other shareholders and the best interests of the entity. The risk is that the minority owner could require the entity to report for non-business reasons.

Table 31: Opting out of financial reporting by not-for-profit entities (separation indicator only)

Issue	The separation indicator applies to all not-for-profit entities. There is a need for a rule to permit members to opt out of preparation if the separation indicator is the only one that applies.
Status quo	The separation indicator is not being applied at present.
Proposal	Opt out would apply if a simple majority of all members of the entity supported the motion. This would mean, in effect, that abstentions are a vote against an opt-out motion.
Costs and benefits	A comparison of costs and benefits with the status quo is irrelevant. The counterfactual, in this case, is the other option discussed in the "other options considered" cell.
Other options considered	We also considered the option of 95% of members who vote on the motion. However, the absence of ownership rights in most not-for-profit entities reduces the incentive on members to attend meetings. In addition, proxy voting is far less common in the NFP sector. Therefore, we concluded that opt out should only be permitted if it is clear that the majority of members support the proposal.

Table 32: Opting into assurance by small and medium not-for-profit entities (separation indicator only)

Issue	There is a need for an assurance opt-in rule for entities that have annual operating expenditure of less than \$150,000.
Status quo	The separation indicator is not being applied at present.
Proposal	Opt in would apply if 5% of all members of the entity supported the motion.
Costs and benefits	A comparison of costs and benefits with the status quo is irrelevant. The counterfactual, in this case, is the other option discussed in the “other options considered” cell.
Other options considered	We also considered the option of 5% of members who vote on the motion. However, we concluded that it would be confusing if the preparation opt-out rule was based on total members and the assurance opt-in rule was based on members who voted.

Table 33: The definition of economic significance (for-profit entities)

Issue	The issue is to establish a clear proxy for economic significance.
Status quo	The only economic significance test appearing in the Financial Reporting Act at present relates to companies that have 25% or more overseas ownership. Such companies are required to file audited GPFR if they meet or exceed two or more of the following three tests: annual revenue of \$20m, total assets of \$10m and 50 FTE employees. This test is also used as one of the three criteria for reporting under the second rather than the first tier of reporting.
Proposal	\$30m revenue or \$60m assets.
Costs and benefits	See the “other options considered” cell below.
Other options considered	<p>We also considered (a) introducing a revenue only test, and (b) retaining the 2-out-of-3 test. The revenue-only approach is the simplest of the three options. In addition, revenue is the best measure of economic significance because it measures business activity. However, the assets test is a useful back-up because aggressive tax planning issues can be significant at this level. Retaining the employee criterion would retain the greater complexity associated with the current system without adding any obvious benefits.</p> <p>We also considered alternative dollar threshold options. However, we concluded that the current \$20 million should be increased to \$30 million for annual revenue because (a) it is easier to meet a one-out-of-two than a two-out-of-three criterion; and (b) The time value of money – The current dollar numbers were introduced in January 2007. It is likely that the changes would not come into force any earlier than late 2012 and would not be further increased until 2017.</p>

Table 34: The definition of economic significance (not-for-profit entities)

Issue	The issue is to establish a clear proxy for economic significance.
Status quo	The economic significance indicator is not currently applied in the NFP sector.
Proposal	\$30m annual operating expenses.
Costs and benefits	See the “other options considered” cell below.
Other options considered	<p>Expenditure is a better measure than revenue in the NFP sector because it tends to vary less from year-to-year. In addition, revenue and expenditure tend to equate in the medium term. A total asset test is not a good measure of economic significance in the not-for-profit sector because assets are often held for non-economic reasons.</p> <p>We also considered whether a higher figure than \$30m should be used because a single criterion is easier to meet than a 1-out-of-2 test. However, we concluded that it would be simpler if the dollar figure was the same for NFPs and for-profits</p> <p>We also considered a 3-year rolling average to reduce the risks associated with variations in expenditure from one year to another. However, we also rejected that option for reasons of complexity.</p>

Table 35: Changing the monetary thresholds

Issue	Entities can move from less to more demanding reporting obligations due simply to inflation. It is important to have a workable mechanism for changing the amounts.
Status quo	Dollar thresholds can only be changed by Parliament through primary legislation.
Proposal	Introduce a mechanism to allow all dollar amounts included in primary legislation to be changed by the Government in secondary legislation. This proposal would apply to the dollar amounts for determining whether an entity is economically significant and the cut off points for not-for-profit entities for cash versus accrual reporting and no assurance versus assurance. The first changes would take place after a qualitative review of the initial criteria. The subsequent changes would be made no less than every 8 years and would be index-linked.
Costs and benefits	Introducing the proposed change will lead to changes being made more frequently. Therefore, it will reduce the risks of unnecessary compliance due to inflationary drag effects.
Other options considered	We also considered whether to index-link from the outset rather than carrying out a qualitative review on the first occasion. However, many of the thresholds have not been tested and we concluded that a qualitative review is needed to test whether the thresholds work well in practice. We also considered 5 or 10 year options for changing the numbers based on indexing. A five year adjustment would be too frequent because, at current inflation rates, the increases would be less than 15%. Eight years would represent 20-25%, which is large enough to warrant making a change.

Table 36: The preparation and filing deadline for issuers and companies

Status quo	Issuers and companies are required to complete financial statements within five months of the end of the financial year. Those that have filing requirements must file the audited financial statements within another 20 working days.
Issue	The International Monetary Fund expressed concern about the status quo because unlisted issuers are not subject to continuous disclosure obligations. Therefore, users are largely or fully reliant on GPFR and six months is not sufficiently timely to adequately meet their information needs.
Proposal	Reduce the preparation time from 5 to 3 months.
Costs and benefits	The main cost will be to place greater pressure on preparers and auditors. However, we agree with the IMF that it is imperative for users to have access to the financial statements in a timely manner and that the current 5 months plus 20 days timeline does not meet that objective.
Other options considered	We also considered reducing the time by one month rather than two. However, our preferred option is consistent with public sector deadlines and it is reasonable to expect the private sector can match public sector performance.

CONCLUSIONS AND RECOMMENDATIONS

- 22 The main aim of financial reporting is to find an appropriate balance between the benefits of transparency and accountability to users and the compliance costs associated with financial reporting. We have concluded that this balance is achieved most of the time by applying the three indicators of financial reporting.
- 23 The indicators have been departed from in a minority of cases for two reasons. First, it was not possible, in two cases, to state that all of the entities fit within the definition of a single indicator (i.e. incorporated societies and charitable trusts). Secondly, in some cases material costs or benefits are not fully recognised by the indicators. The main examples are:
- The proportionately high fixed costs of financial reporting for small registered charities;
 - The need to fit financial reporting with the broader regulatory objectives in relation to gaming machine societies and retirement villages; and
 - The proportionately high reporting-related costs arising from the dispersed beneficial ownership of small Māori asset governance entities.

- 24 We considered that suggestions to modify the indicators to take a broader view of public confidence into consideration were inconsistent with the objective of finding an appropriate balance between benefits to users and costs to preparers. Our view is that the public confidence concern is largely met by applying the economic significance indicator. We also consider that the economic significance indicator is wholly consistent with the government statement on regulation dated 17 August 2009.
- 25 Our main conclusions are:
- That the already rigorous reporting requirements for government entities and for issuers of securities should be retained;
 - That substantial compliance cost savings can be achieved for medium-sized and, to a lesser extent, small companies by removing the general reporting obligations on those companies and replacing them with special reporting under the Tax Administration Act; and
 - That the quality of reporting by registered charities is highly variable and needs to be improved. Significant improvements can be achieved by empowering the XRB to approve simple format reporting templates and introducing an assurance requirement for the largest 20-25 percent of registered charities.
- 26 Several minor and supporting changes are also required to make the financial reporting system fully effective.

CONSULTATION

Public comment on the Ministry's discussion document

- 27 The Ministry received 151 submissions on a discussion document that was released on 30 September 2009. About half of them related predominantly or exclusively to whether a new requirement should be introduced to require large non-issuer companies to file. The Minister of Commerce decided to retain the status quo in early 2010 after consulting with other senior ministers.
- 28 NZICA stated in its submission that it was generally supportive of the direction for reform indicated in the discussion documents simultaneously released by MED and the Accounting Standards Review Board (the forerunner of the XRB). NZICA stated in particular that "we are pleased that many entities will have reduced reporting obligations" and that "many [members] currently view as imposing costs but providing little if any benefit. The compliance burden of the current financial reporting framework has been a concern for many of our members and reforms to reduce and streamline financial reporting are therefore welcome." We agree, in full or part, with most of the suggested changes NZICA has proposed on more specific issues.

- 29 Three of the Big 4 accounting firms made submissions on a wide range of issues. The exception, KPMG, stated that they found themselves conflicted on many aspects of the proposed changes and, other than one specific issue that is not addressed in this RIS (because Ministers have already made decisions on it), limited their response to very general comments.
- 30 Deloitte and Pricewaterhouse Coopers (PwC) both stated that there is a second objective for financial reporting in addition to the one described in Paragraph 4 of this RIS.
- 31 Deloitte stated that financial reporting is important to establish a minimum level of financial discipline to promote confidence in the healthy functioning of business and public benefit activities and to enable compliance with an entity's statutory obligations such as the requirement to keep proper accounting records, to comply with the solvency test and to not trade recklessly. PwC stated that GPFR, even if not published, yields significant benefits by assisting the efficient operation of the economy. Although PwC believe that all well run and responsible companies will continue to prepare annual financial statements, the less well run and irresponsible will not. It is this latter group that is concerning. Ernst & Young (EY) agreed with the primary principle and the three indicators described in the discussion documents, as summarised in Paragraph 5 of this RIS.
- 32 The proposals for SPFR for tax purposes have largely been developed since the release of the discussion document. Our view is that those proposals meet most of the concerns expressed by Deloitte and PwC.
- 33 Deloitte also stated that the increased burden for some entities, such as private not-for-profit entities does not appear to be backed up by any compelling statistical or other research. They expressed concern that the costs of reporting may outweigh the benefits. Our view is that the subsequent Cordery & Patel and Sinclair research support the case for the proposed changes.
- 34 EY and PwC broadly supported the not-for-profit sector proposals. However, PwC stated that the operating expenditure-only criterion for determining tiers of reporting would not be adequate for asset-rich entities that use income generated from a strong asset base to support their objectives. They also suggested an asset criterion.
- 35 All three firms suggested modifications to other preliminary positions expressed in the MED discussion document, some of which have been incorporated in part or whole into the preferred options in this RIS.

Subsequent targeted consultation

- 36 We subsequently consulted with targeted stakeholders in formulating our final views. We consulted very closely with the ASRB/XRB in particular because of the strong links between the “who” questions that the government needs to consider and the “what” questions that the External Reporting Board will need to consider in carrying out its statutory functions as an independent Crown entity.

Future targeted consultation

- 37 The one remaining significant issue is whether assurance should be required for larger registered charities and, if so, how a large charity should be defined. The analysis of the costs and benefits would benefit from targeted consultation with the main umbrella groups in the not-for-profit sector, some of the larger charities and the Charities Commission. We propose to carry out such consultation in early 2012.

Public sector consultation

- 38 The issues are of interest to a large number of other government entities. We have consulted with:
- The Treasury on the full range of issues
 - Inland Revenue from a tax base protection perspective
 - The Office of the Auditor-General on public sector entities
 - The Department of Internal Affairs on local government entities, not-for-profit entities and gaming machine societies
 - The Office of the Community and Voluntary Sector on not-for-profit entities
 - The Charities Commission on registered charities
 - Sport and Recreation New Zealand on incorporated societies
 - The Ministry of Justice on charitable trusts and Bill of Rights Act issues
 - Te Puni Kokiri, the Māori Trustee and the Māori Land Court on Māori asset governance entities
 - The Securities Commission and the Reserve Bank on issuers
 - The Ministry of Foreign Affairs on overseas companies
 - The Department of Building and Housing on retirement villages
 - The Law Commission on incorporated societies and the law of trusts
 - Statistics New Zealand on statistical data issues
 - The Registrar of Companies on registry issues
- 39 The two departments we have worked most closely with are Inland Revenue and the Department of Internal Affairs, including the Office of the Community and Voluntary Sector.

- 40 Inland Revenue objective is to ensure that the proposed removal of the GPFR requirements would not adversely affect the tax base. MED fully supports that goal and the two departments have agreed an approach that reflects those concerns. Inland Revenue will develop and implement SPFR requirements under the Tax Administration Act and for the GPFR requirements to be removed no earlier than the tax changes are brought into force.
- 41 DIA's main concerns relate to possible fragmentation of the not-for-profit sector if different classes of entities have different financial reporting requirements. MED's focus was on consistent application of the indicators. The two departments have agreed that the way of dealing with this is through sector education about the benefits of robust financial reporting. This could include promotion of the two forthcoming XRB simple format templates for use by not-for-profit entities that do not have statutory financial reporting obligations.

IMPLEMENTATION

- 42 A bill will need to be passed by Parliament to give effect to the changes. The aim is to introduce legislation in early 2012 with a view to enactment in late 2012 or early 2013. There will need to be different implementation dates depending on the following matters:
- The completion of the tier setting process by the External Reporting Board
 - The adjustment time that each class of reporting entity will need and the need to publicise changes in an effective manner
 - The implementation date for the tax special reporting regime that will apply to small and medium companies
- 43 The main implementation risk is that the Inland Revenue SPFR changes might reverse the GPFR compliance cost savings. This is not a risk in relation to medium-sized companies because they will be moving from moderately complex second tier reporting to simple format reporting. There is a risk in relation to small companies. Stakeholders will have the opportunity to identify and comment on any perceived excessive compliance when Inland Revenue consult publicly on the proposed SPFR requirements.

MONITORING, EVALUATION AND REVIEW

- 44 There is little point in reviewing the fundamental issue of whether issuers or government entities should be required to publish audited financial statements. There is a strong consensus that such reporting is fully appropriate. The main issue is whether the actual disclosures are useful. This is a matter for the XRB, as an independent Crown entity. We understand that the standards setters currently obtain useful feedback on existing disclosures through the release of exposure drafts that propose the modification of extant standards.
- 45 The impacts of some of the proposed changes will not become fully evident until after they have been brought into force. The Ministry intends to seek the views of major stakeholder groups informally from time-to-time after implementation to test whether changes need to be made.
- 46 We also plan to complete a more formal assessment within the first five years, subject to approval by the minister of the day. We anticipate that the major focus will be on small and medium companies and registered charities. That assessment will include the qualitative review of all the currency criteria, as discussed in Table 36. We also propose to maintain contact with the Charities Commission and academics that specialise in researching not-for-profit reporting with a view to keeping up to date with research that assesses whether the changes have been effective.

APPENDIX ONE: DEFINITIONS

Generally accepted accounting practice (GAAP)

GAAP is predominantly the set of financial reporting standards approved by the Accounting Standards Review Board. However, because standards cannot cover every conceivable situation, GAAP also includes accounting policies that are appropriate in the circumstances of the reporting entity or have authoritative support within the accounting profession. The legal definition of GAAP appears in section 3 of the Financial Reporting Act 1993.

General purpose financial reporting/reports (GPFR) and special purpose financial reporting/reports (SPFR)

GPFR is financial reporting that is carried out in accordance with GAAP or, to put it another way, financial reporting that is regulated under the Financial Reporting Act. GPFR is designed for external users (e.g. investors) who have a need for an entity's financial statements but are unable to demand them. Because those external users can have diverse information needs, financial reporting standards require a large number of disclosures to cover the information needs of all of the main potential users.

Special purpose financial reporting/reports (SPFR)

SPFR relates to users who can demand financial information in accordance with the requirements that fit their specific needs. For example, trading banks are special purpose users when they are considering whether to make a loan to a business because they can demand whatever financial reporting meets their needs as a condition of making the loan.

Some regulators can be regarded as being both general and special purpose users. For example, the Reserve Bank needs both GAAP-compliant and special purpose information (e.g. capital adequacy ratio data) for prudential regulation purposes.

Accrual accounting

Accrual accounting requires revenues and expenses to be recognised when they are incurred, regardless of when cash is exchanged. This means, for example, that:

- A payment received for goods and services in advance must be treated as a liability. It should not be treated as revenue until it has been earned.
- Expenditure on an item with an economic life of more than a year must be treated as an asset (not an expense) and depreciated or amortised over the economic life of the asset.

Cash-in/cash-out accounting

The reporting treatment under cash-in/cash-out accounting is largely determined by the timing of the exchange of cash. Cash accounting reporting may be satisfactory for small entities that do not make or receive any significant prepayments, do not grant or obtain loans, or have no significant assets or liabilities with an economic life of more than one year. However, if these conditions do not apply, then cash-based statements will be misleading if they mistakenly treat assets (e.g. a motor vehicle) as expenses and liabilities (e.g. a bank loan) as revenues.

Reasonable and limited assurance

There are two types of assurance:

- A reasonable assurance engagement (i.e. an audit) provides the basis for a positive form of expression of the practitioner's conclusion on whether the financial statements are prepared, in all material respects, in accordance with GAAP. An extract from standard wording used in an unqualified audit opinion is as follows:

We planned and performed our audit so as to obtain all information and explanations which we considered necessary in order to provide us with sufficient evidence to obtain reasonable assurance that the financial statements are free from material misstatements, whether caused by fraud or error.

- A limited assurance engagement (i.e. a review) provides the basis for a negative form of the expression of the practitioner’s conclusion. An extract from standard wording used in an unqualified review opinion is as follows:

Based on my review, nothing has come to my attention that causes me to believe that the accompanying financial statements do not give a true and fair view.

Users obtain a higher level of assurance from an audit than a review that the financial statements are free from material error.

APPENDIX TWO: FRAMEWORK FOR DETERMINING WHICH CLASSES OF ENTITY SHOULD HAVE GENERAL PURPOSE FINANCIAL REPORTING (GPFR) OBLIGATIONS AND, IF SO, WHAT THOSE OBLIGATIONS SHOULD BE

