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OFFICE OF THE MINISTER OF COMMERCE

The Chair
CABINET ECONOMIC GROWTH AND INFRASTRUCTURE COMMITTEE

REVIEW OF FINANCIAL REPORTING FRAMEWORK: PRIMARY ISSUES

PROPOSAL

1 Following discussion at EGI in May 2011, I submit this revised paper. In this paper I am proposing revisions to the Financial Reporting Act 1993 (the FRA) and other legislation consistent with the principles and indicators of financial reporting. There is an accompanying secondary issues paper.

2 When EGI considered these papers in May I was invited to submit revised papers which include further consideration and advice on:

a The implications of the proposals in relation to:

i Charities and other not-for-profit entities (Paragraphs 83-99)

ii The growth of small and medium companies (Paragraphs 35-37 and 159)

iii The requirements of creditors (Paragraphs 38-47 and 159)

b The consequential work to be undertaken by the Inland Revenue Department, and the likely timeframes involved (Paragraphs 57-61)

TERMINOLOGY

3 The following terms, which are used throughout this paper, are defined and discussed in Appendix One:

- Generally accepted accounting practice (GAAP)
- General purpose financial reporting/reports (GPFR)
- Special purpose financial reporting/reports (SPFR)
- Accrual accounting and cash-in/cash-out accounting
- Reasonable and limited assurance (i.e. audit and review respectively)

EXECUTIVE SUMMARY

4 The FRA and other legislation impose obligations on classes of entities to prepare financial reports in accordance with GAAP. These obligations are aimed at assisting economic decision making and promoting accountability, transparency and confidence. While many of the existing reporting settings are sound, some other requirements are inconsistent with the objectives of financial reporting. I am proposing two major changes and a number of smaller but collectively significant changes that will improve the financial reporting system.

5 First, I am proposing to remove the requirements on medium and small companies to prepare GPFR in accordance with GAAP. A consequence is that the Inland Revenue Department will need to add to the SPFR preparation requirements under the Tax Administration Act 1994. It would be necessary to have those changes in place before the GPFR obligations are removed. Nevertheless, the expectation is that there will be a very substantial reduction in compliance costs, particularly for medium-sized companies. The total compliance saving could amount to $90 million or more a year.

6 I am also proposing to improve the reporting system for registered charities, which is currently incomplete. There are no standards to guide what must be prepared and filed, and some registered charities are still coming to terms with the obligation to file financial statements. Issues include the following:

a A wide variety of formats and bases are being used for financial statement compilation, making it difficult to compare charities

b Some charities are making fundamental mistakes such as not including donated assets on their balance sheets, or treating loans as revenues rather than liabilities

c Some charities aim to "look poor" (for example, by moving assets to subsidiary trusts) as they seek to gain more funding

d Many registered charities are not providing appropriate notes and/or accounting policy statements to enable the financial statements to be understood.

7 I am proposing two main changes to substantially reduce these problems. First, the External Reporting Board (XRB)[1] should be empowered to make standards for registered charities and the other classes of not-for-profit entities that have reporting obligations. Secondly, the reporting system would be tiered based on entity size. Currently the XRB is considering an approach whereby the largest 5% of charities would prepare reasonably sophisticated financial statements. The remaining 95% would complete simple format reports.

8 This will provide greater certainty for charities that do not know what is expected of them, particularly those who rely on volunteers who do not have accounting skills. It

[1] The XRB was established on 1 July 2011. It is effectively a reconstitution of the Accounting Standards Review Board, but with a much wider range of functions.

should also increase the quality of the reporting and improve comparability and the reliability of aggregate data.

9 Education and other support targeted at the not-for-profit sector will be essential to improve the quality of financial preparation and reporting standards, help them overcome the costs of adopting the new regime, and better use of financial reports by funding agencies. Officials will work with the Charities Commission, NZICA, the XRB and non-profit organisations to develop an appropriate support package to implement these proposals and minimise any compliance costs.

SUMMARY OF PROPOSALS

10 The impacts of the proposals in this paper can be summarised as follows:

No changes proposed

- Public sector entities
- Issuers, including deposit takers and fiduciaries
- Large companies that have 25% or more overseas ownership
- Large companies that are incorporated overseas
- Small and medium trading trusts
- Small and medium partnerships
- Sole traders[2]
- Incorporated societies
- Charitable trusts
- Large industrial and provident societies
- Unincorporated societies
- Māori trust boards
- Māori reservations

Table One: Changes proposed

Class of entity	Change	Impact
Large companies	Remove the requirement to prepare parent entity financial statements and leave it to the XRB to determine any parent company reporting obligations.	Small compliance cost reduction.
Medium-sized companies	Replace GPFR preparation requirements with simplified SPFR for tax purposes.	Large compliance cost reduction, perhaps $50 million a year.

[2] Although no financial reporting changes have been recommended for sole traders, and small and medium partnerships and trading trusts, IRD has indicated that it will review the current SPFR filing requirements for these classes of entity as it develops SPFR for small and medium companies.

Small companies	Replace simple format GPFR with SPFR for tax purposes.	Compliance costs will be no higher than at present and might be lower. A $100 reduction per company would result in compliance cost savings of $40 million a year.
Medium and small limited partnerships	Remove the existing preparation requirement.	Small compliance cost saving only because there are less than 1,000.
Large trading trusts, limited partnerships and partnerships	Introduce requirements to prepare GPFR, have them audited and distribute to the owners.	Small compliance cost increase. The change will only affect a small number of entities.
Small and medium registered charities (operating expenditure <$2 m)	Current reporting quality is poor because there are no standards. Empower the XRB to set standards in a simple format.	Higher quality and more consistent reporting. Reduced compliance costs and greater certainty for preparers.
Large registered charities (operating expenditure ≥$2 m)	As for small and medium registered charities, but require preparation in accordance with GAAP.	Higher quality and more consistent reporting. Reduced compliance costs and greater certainty for preparers.
Medium and small industrial and provident societies	Remove the requirement to include financial statements in the annual return.	Very small compliance cost saving
Friendly societies that offer insurance services, and credit unions	Retain the requirement to file audited financial statements but remove Registrar monitoring and reporting.	Very small administrative cost reduction.
Other friendly societies	Retain preparation, assurance and distribution to members, but remove the filing requirement.	Small compliance cost reduction.
Gaming machine societies that operate machines in commercial venues	All gaming machine societies must prepare GPFR. Publication obligations vary according to the society's legal form. Introduce a consistent requirement to file audited financial statements.	Very small compliance cost increase due to the new filing requirement for some societies.
Gaming machine societies that operate machines almost exclusively in their own premises	Require societies to distribute audited financial statements to members.	Most societies are likely to be distributing already. Very small compliance cost increase.
Retirement villages	Remove the presumption that retirement villages are issuers. This would allow most to report in accordance with the second rather than the top tier of reporting.	The compliance cost savings could exceed $1 million a year.

Large Māori incorporations	In addition to the current preparation and audit requirements, require distribution to all beneficial owners.	Very small compliance cost increase. The change will affect less than five incorporations.
Medium and small Māori incorporations	Remove the audit requirement.	Small compliance cost reduction.
Māori land trusts	The reporting requirements are inconsistent. Empower the XRB to set default requirements but allow the Maori Land Court to vary those requirements to meet individual circumstances.	Small benefit associated with consistent treatment.

BACKGROUND

How financial reporting works

11 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 Whether the class of reporting 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).

12 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.

13 The XRB will be responsible for issuing the standards for each tier of reporting.

The Policy Framework for Financial Reporting

14 The review of the financial reporting framework aims to consolidate and confirm which classes of entity should be subject to GPFR obligations and what those obligations should be (i.e. preparation, assurance, distribution and/or publication).

15 The main issue, when deciding whether a class of entities should be subject to GPFR obligations is whether there are external users who have a need for an entity's financial statements but are unable to demand them. The trade-off that needs to be applied is to weigh the benefits of transparency and accountability against the compliance and any other costs associated with the reporting. There are three "indicators" of financial reporting. If one of the indicators is met, then financial reporting of some sort or another is needed, depending on which indicator applies. The indicators are:

- **Public accountability**: Is the entity owned by or funded directly by the public? If so, it should be required to prepare and publish assured GPFR, unless there are outweighing compliance costs. Public sector entities, issuers (including deposit takers and certain other entities that hold assets in a fiduciary capacity) and entities that receive donations from the public are all publicly accountable.

- **Economic significance**: If the entity is not publicly accountable, is it large? If so, its failure could have significant societal impacts and it should be required to prepare and publish assured GPFR, unless there are outweighing commercial confidentiality and/or privacy-related costs. Even if publication is not justified, the entity should be required to prepare assured GPFR and distribute them to the entity's owners or members.

- **Separation**: If neither of the other two indicators applies, is there a significant degree of separation between management and the owners or members of the entity? If so, 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.

16 If none of the indicators apply, there should be no financial reporting obligations but the owners or members should be able to opt in to preparation, assurance and distribution.

17 This framework appears in flowchart form in Appendix Two and is applied to all classes of entities in this paper comprising:

- Public sector entities
- Private for-profit entities comprising issuers, companies (including co-operative companies), trading trusts, limited partnerships, partnerships and sole traders
- Private not-for-profit entities comprising registered charities, charitable trusts, incorporated societies, unincorporated societies, gaming machine societies, industrial and provident societies, friendly societies and credit unions
- Retirement villages, some of which are for-profit and others not-for-profit
- Māori asset governance entities comprising Māori trust boards, Māori reservations, Māori incorporations and Māori land trusts.

18 Before discussing the application of the indicators to each class of entity, some of the recommendations in the secondary issues paper provide context for considering the primary issues. These recommendations are:

a The higher or highest reporting obligations should apply where an entity falls within two or more categories of reporting entity (e.g. issuer and industrial and provident society)

b To permit medium and small not-for-profit reporting entities to have a review completed as an alternative to an audit

c To permit entities to "opt up" to a higher level of reporting or assurance

d To use the following criteria to distinguish between entities of different size:

i $30 million annual revenue or $60 million assets to distinguish between large and non-large for-profit entities

ii $30 million annual expenditure to distinguish between large and medium not-for-profit entities

iii $150,000 annual expenditure to distinguish between medium and small not-for-profit entities

iv $40,000 annual expenditure to distinguish between small and micro not-for-profit entities

e To change all dollar amounts no less than every eight years by Order-in-Council.

PUBLIC SECTOR ENTITIES

The status quo

19 Central and local government entities must prepare financial statements in accordance with the standards approved by the XRB, have them audited and publish them in one way or another. This category comprises all government entities regardless of whether they are not-for-profit (e.g. government departments) or for-profit (e.g. state-owned enterprises). The Auditor-General is responsible for carrying out all government entity audits and can contract public practitioners to carry them out.

Proposals and rationale

20 There is a strong case for retaining the status quo. All public sector entities are publicly accountable because they are owned and funded by taxpayers and ratepayers, who would not otherwise be able to demand the financial statements. If anything, public sector entities can be regarded as having a higher level of public accountability than issuers and charities because taxes and rates are coercive, whereas the public can choose whether to participate in financial markets or make donations.

FOR-PROFIT ENTITIES

Issuers

The status quo

21 All entities that are defined as issuers in the FRA are required to file audited GPFR with the Registrar of Companies. In a broad sense, the definition of issuer covers:

- Entities that seek funding through equity or debt instruments that are offered to the public; and
- Banks, insurance companies, mutual funds and other entities that take deposits from the public and/or hold assets in a fiduciary capacity for broad groups of outsiders.

22 At present issuer audits must be carried out by a chartered accountant with a public practising certificate or an overseas-qualified person whose qualifications have been recognised by the Registrar of Companies. The Auditor Regulation Act 2011 will introduce specialist licensing for issuer audits, with the regulatory responsibilities to be split between the Financial Markets Authority (FMA) and accredited professional accounting bodies. This regime will come into force no later than 1 July 2012.

Recommendation and rationale

23 There is a strong case for retaining the status quo, as modified by the Auditor Regulation Act. Overseas empirical research demonstrates that financial reporting lowers investor risks (by reducing the costs of identifying investment opportunities and reducing investment errors) and improves corporate governance. Institutional and individual investors use key indicators from financial reports to inform share purchase, hold and sale decisions. Securities analysts, brokers, financial advisers and other intermediaries translate the reports into user-friendly data for clients. Preparers routinely track investor responses to their financial disclosures and respond to perceived investor concerns.

Other Classes of For-Profit Entities

24 Issuers and government-owned businesses are the only categories of for-profit entities that are publicly accountable. The discussion below addresses whether the economic significance or separation indicators apply to the remaining categories of for-profit entities.

Companies generally, including co-operative companies

25 All companies are required to maintain proper accounting records that, among other things, correctly record and explain the transactions of the company and enable the financial position of the company to be determined with reasonable accuracy at any time. I am not proposing any changes to this requirement. It is needed for corporate governance reasons. It is also linked to the general scheme of the Companies Act to protect the interests of creditors, to support various forms of regulation and other purposes such as protection of the tax base. The discussion below relates only to whether the various classes of company should be required to prepare GPFR and, if so, whether they need to be audited, distributed to owners and/or published.

Large Companies That Are Not Overseas Incorporated Or 25% or More Overseas Owned

The status quo

26 This class of companies is required to distribute audited GPFR to shareholders. After consulting with other senior economic ministers, last year I decided that there would be no new requirement for such companies to file GPFR with the Registrar of Companies. My reasons related largely to the need to protect commercially sensitive information and privacy concerns in relation to closely-held family-owned companies. The remaining issue is whether there is a case for retaining the preparation and audit requirements.

Recommendations and rationale

27 The preparation and audit requirements should be retained for the following reasons:

a The failure of a large non-issuer company can have significant adverse impacts on society. GPFR can contribute to avoiding business failure;

b There would be no noticeable compliance cost savings by removing the preparation requirement. Only a very small percentage of companies are large and the cost of filing is close to zero. In addition, most if not all large non-issuer companies would choose to prepare sophisticated financial statements for internal purposes even if they were not obliged to prepare GPFR; and

c The disadvantages associated with filing (i.e. loss of commercially confidential information and, for closely held companies, the loss of privacy) do not apply in relation to preparation and distribution.

Large companies that have 25% or more overseas ownership

The status quo

28 Large companies with 25% or more overseas ownership must prepare and file audited financial statements.

Recommendation and rationale

29 I recommend that the status quo be retained. 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.

Medium and small companies

The status quo

30 Medium-sized companies are required to prepare financial statements in accordance with the second tier of standards approved by the XRB (i.e. the Framework for Differential Reporting) or in accordance with the New Zealand standards that applied prior to the adoption of International Financial Reporting Standards (IFRS). This set of standards, which is commonly referred to as “Old GAAP” have not been maintained since 2002 and are out-of-date.

31 Small companies are also required to prepare but can do so in accordance with the simple format reporting requirements of the Financial Reporting Order 1994. The default in relation to assurance is that all companies must appoint an auditor, but opt out is available if the shareholders unanimously agree. The auditor must be a chartered accountant or an overseas-qualified person whose qualifications have been recognised by the Registrar of Companies. There is widespread non-compliance with the auditor appointment requirements among small companies. Most neither appoint an auditor nor put the required motion to a meeting of the company.

32 In addition, there is almost no monitoring of compliance with the preparation requirement and public enforcement is rarely a priority. This encourages some small companies to ignore their GPFR preparation obligations. The absence of monitoring also encourages some medium-sized companies to prepare in accordance with the much simpler small company standards.

Financial discipline

33 It was suggested by some submitters in response to a Ministry of Economic Development discussion document that preparation requirements are needed because it imposes a minimum level of financial discipline and, therefore, contributes to public confidence in the healthy functioning of business.

34 An alternative perspective is that tax returns and information required by banks provide basic financial information for internal governance purposes. In addition, the New Zealand Institute of Chartered Accountants (NZICA) announced last December that if the preparation requirements for small companies were to be removed it will develop a new set of condensed guidelines for SMEs, accountants, auditors and users. NZICA's focus would be to ensure that the guidelines are robust, simple to use and fit for purpose.

The impact on the growth of small and medium companies

35 Companies need to have strong governance including high quality management accounting systems to provide timely and relevant financial information to the directors and to the entities or individuals who are providing capital. A company's growth business plan needs to explain how the growth is going to be achieved (e.g. by expanding sales in existing markets, moving into new geographical markets and/or developing new products). The financial information contained in the plan also needs to have a forward-looking focus, with the main emphasis being on cash projections, not GPFR.

36 GPFR can contribute to growth strategies but there are some limitations because they are usually not finalised until five or more months after the end of the financial year. In addition, the enhanced SPFR that will be required for tax purposes are likely to be able to make much the same contribution as GPFR do to supporting company growth strategies.

37 In addition, businesses need capital injections to grow. If an entity seeks money from the public then it is an issuer and is required to file audited GPFR.

The impact on the interests of creditors

38 Setting aside IRD and other government agencies that have statutory powers to obtain financial information, there are two types of creditors:

a Creditors who have the power to demand financial information as a condition of doing business – Banks are a prime example; and

b Creditors who do not have the power to demand financial information as a condition of doing business – Most trade creditors and consumers who pre-pay for goods and services fall into this category.

39 For the reasons outlined below, I consider that the proposal to remove the preparation requirement for small and medium companies will have no material impact on either group.

Banks

40 Banks require annual financial statements from businesses that are seeking to borrow and have borrowed money from them[3]. They require those financial statements to be prepared by a chartered accountant for credibility and independence reasons. However, the historic financial statements the banks demand are SPFRs because they include only basic financial information. The reports are not the GPFRs required to be produced under the Companies Act because they do not include many of the detailed disclosures that are required of medium-sized companies by the approved standards.

41 In addition, banks obtain other information that is not part of GAAP for small and medium companies. Other than historical financial statements, the banks also require management accounts to be provided no less than annually. Small and medium businesses with higher risk profiles are required to provide additional information such as cash flow projections, and lists of debtors and creditors. This information is very important in these circumstances because the banks' major risk relates to default due to cash flow problems or insolvency. Higher risk lenders are also generally required to provide information by the banks more frequently (e.g. quarterly).

42 Representatives of some of the banks consulted by officials stated that the GPFR requirements should be retained due to concerns that if the requirement to prepare was removed, it would be more difficult for the banks to obtain financial statements. An alternative perspective is that banks are in a strong position to demand whatever financial information they require from business borrowers. Banks can and do demand non-GAAP financial information from companies without any statutory backing, they also demand financial reports and other information from trading trusts, partnerships and sole traders, none of which have statutory financial reporting obligations.

43 I consider that banks have sufficient strength to demand the information they need as a condition of lending to their business customers. I have concluded, therefore, that removing the GPFR requirement will not harm the interests of banks.

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[3] They will also obtain information about the financial affairs of the proprietors where personal guarantees have been given, which tends to be very common for small businesses.

Creditors who cannot demand information

44 A company's latest GPFR can provide creditors and their advisers (e.g. credit rating agencies and business analysts) some useful information about a company's financial position, although caution needs to be exercised because they can be anywhere between 5 and 17 months old. If creditors could obtain access to GPFR some would have the opportunity to consequentially alter their behaviour (e.g. by demanding cash payment on delivery for goods, or advance payment for services).

45 However, most credit managers and controllers do not have the power to demand GPFR or other financial information. Therefore, removing the preparation requirement would not make any difference unless Parliament was to introduce a requirement for all companies to publish GPFR (e.g. by filing them with the Registrar of Companies).

46 Other than providing information that would be of some direct use to creditors, publication could also encourage the directors of insolvent companies to act earlier. Financially distressed companies usually continue to trade while technically insolvent and the total losses usually grow substantially in the period prior to formal insolvency. The transparency associated with a requirement to file GPFR within, say, four months of balance date may encourage boards to liquidate insolvent companies at an earlier date, thereby reducing the total losses incurred by creditors.

47 I considered the possibility of introducing filing for large non-issuer companies early last year and after consulting with other senior economic ministers, I concluded that a filing requirement should not be introduced.Although the direct cost of filing is small, perhaps $30 per company[4], there are two potentially more significant costs, which are not readily quantified:

- a GPFR can, in some circumstances, reveal commercially confidential information. For example, it can be a major issue where there are strong links between the location of a business and its profitability (e.g. some retailing businesses); and
- b There are privacy issues. GPFR can disclose information about the wealth of individuals or a family where the company is closely held, particularly where a family's business interests are consolidated within a single group.

48 The arguments for requiring filing of GPFR by all companies, regardless of size, are weaker for the following reasons:

- a When a large company fails, smaller trade creditors can consequentially fail. The failure of individual non-large companies does not have the same domino effect risks;
- b The direct costs of filing are significant, given that an additional 450,000 companies would need to file. If $30 cost per filing is assumed, then the compliance costs would be $13.5 million a year; and
- c Almost all non-large companies are closely held, raising wider privacy issues.

[4] If 5,000 large non-issuer companies had to file, the total compliance cost would only be about $150,000 a year.

Recommendations and rationale

49 Medium and small companies are, by definition, not economically significant. Therefore, medium and small companies need only be considered in terms of the separation indicator, which is not being applied at present. A simple proxy for the separation indicator is needed. I am proposing the following for companies that do not meet either of the other indicators of financial reporting:

a A default for companies that have 10 or more shareholders to distribute assured GPFR to shareholders, with the assurance engagement being carried out by a chartered accountant or a licensed auditor. However, the company will be able to opt out of (i) assurance, or (ii) assurance and preparation, if shareholders representing at least 5% of the voting shares by value do not oppose opting out; and

b A default for companies with fewer than 10 shareholders to have no GPFR preparation requirements. However, the company will be able to opt in to (i) preparation or (ii) preparation and assurance by an auditor of their choice if shareholders representing at least 5% of the voting shares by value support an opt-in proposal.

50 The opt-out provision will provide a means to avoid unnecessary compliance costs. The opt-in provision for companies with fewer than 10 shareholders is needed to protect the interests of minority shareholders.

51 New Zealand companies that are not issuers do not have to file financial statements. I am recommending that the status quo be retained in relation to filing.

Consequential changes if the preparation requirements for small and medium companies were to be removed

52 There are two consequential issues.

53 First, there would be a need to introduce SPFR preparation requirements for small and medium companies under the Tax Administration Act if the GPFR requirements were to be removed. SPFR preparation will be necessary for tax purposes to determine taxable income, to assist debt collection and to satisfy information requirements under international treaties.

54 The IRD is better placed than any other agency, including the XRB, to determine its own financial information needs. Conceptually, such a situation would be no different to other government agencies that require financial information to be disclosed for special purposes, such as the Commerce Commission, which sets input methodologies for the purpose of regulating monopolies.

55 IRD has advised that if the Government was to agree to these proposals then it could, and likely would specify SPFR preparation requirements under the Tax Administration Act 1994 for a variety of other non-corporate business taxpayers that are not currently subject to any legislative obligations to prepare financial statements of any sort. IRD has estimated that it would need at least 18-24 months to design a comprehensive new system. IRD has also advised that while it may be able to absorb the ongoing policing costs, it seems much less likely that this will be the case

with any initial set up costs. Small and medium companies should continue to prepare GPFR until the new regime is rolled out.

56 Secondly, it would be necessary to make consequential changes to the solvency test in the Companies Act. It states that directors may only make distributions to shareholders and enter into amalgamations if the company would be solvent in both a balance sheet and cash flow sense immediately after the transaction is completed. It also states that the directors must "have regard to" the most recent GPFR in making such decisions. It would be necessary to modify that requirement insofar as it relates to companies that would no longer have GPFR preparation requirements. I am proposing a more general requirement on the directors of those companies to have regard to financial statements that are relevant in the circumstances.

Compliance cost implications

57 As a general rule, the compliance costs associated with SPFR tend to be lower because the special purpose user can require the preparer to only provide the information that is needed for the special purpose. By contrast, the standards setters that determine the GPFR requirements need to take the information needs of diverse users into account and the number of disclosures is, therefore, greater. As a result of the changes outlined above, the number of companies that would be required to prepare GPFR would decline from about 460,000 to less than 10,000. The compliance cost implications are as follows:

- **Medium-sized companies**: Replacing the requirement to prepare GPFR with tax-related SPFR would mean that medium-sized companies could move from moderately complex reporting under the Framework for Differential Reporting and Old GAAP to simple format reporting. This change would remove many of the current disclosures. Some individual companies could save more than $10,000 a year by not having to prepare the notes to the accounts that are of no use for internal governance, tax, solvency test or other purposes. There are no reliable data on the number of medium companies. However, if 10,000 companies saved an average of $5,000, the compliance cost savings would be $50 million a year.
- **Small companies**: There would be no compliance cost saving for small companies that already fail to comply with the legal obligation to prepare GPFR. However, for the great majority that do comply, the only thing that is known at present is that the compliance costs will be no greater under the tax SPFR rules than they are at present. Assuming a compliance cost saving of $100 a year for 400,000 small companies then the compliance cost savings would be about $40 million a year.

Consequential work to be undertaken by the Inland Revenue Department

58 The small and medium company reform proposals would replace GPFR with tax-related SPFR. This change will mean that it will become IRD's legislative responsibility to set, maintain and enforce the SPFR requirements.

59 The work will be done in collaboration with NZICA. NZICA plans to produce best practice guidelines for special purpose reporting for about six industry groups (e.g. farm accounting), subject to the Government announcing that it will remove the general purpose reporting requirement for small and medium companies. The plan includes leveraging off guidelines prepared by professional accounting bodies in other countries that do not have GAAP reporting requirements for small and medium companies (e.g. South Africa). It also includes consultation with members and stakeholders (e.g. software providers) and testing and piloting before the guidelines are finalised.

60 NZICA's aim is to produce guidelines that focus on the needs of shareholders. They will also include guidance on reconciliation from the financial statements for shareholders' needs to tax and banking purposes. IRD has accepted an offer from NZICA to include two persons on the steering committee for the project.

61 IRD proposes to leverage off this work. It should mean NZICA will do most of the detailed SPFR work, especially in relation to accounting policies and standards (e.g. accrual accounting and income recognition issues). IRD's role as the regulator will be:

a To propose and support the enactment of an amendment to the Tax Administration Act 1994 – The amendment would require specified taxpayers to prepare financial statements in accordance with the requirements set by IRD. The actual requirements are likely to be set by Order-in-Council, as is the case with the current Financial Reporting Order for small companies;

b To actively participate in the NZICA steering committee process, and provide guidance and constructive feedback; and

c To set the minimum requirements for companies consistent with NZICA's guidelines and consider how those requirements might apply to other classes of for-profit entity.

62 IRD has advised that it can fit within NZICA's 18-24 month project plan as long as the NZICA outputs are timely and reasonably targeted. This would seem very likely because NZICA has strong commercial incentives to produce guidelines that will be fully consistent with IRD's needs.

Overseas Companies Generally – International Obligations

63 New Zealand's free trade agreements and the Schedule of Specific Commitments under the WTO General Agreement on Trade in Services include reservations that provide for additional financial reporting obligations that are currently required under the FRA and Companies Act, in relation to overseas-owned and overseas-incorporated companies. The specific recommendations outlined below include proposals to remove some of those obligations. In respect of New Zealand's free trade agreements, any unilateral liberalisation to these obligations will be automatically applied and subject to standstill with no roll-back mechanisms. Therefore, it will not be possible to reverse any such changes or impose additional obligations or requirements once the changes are made without breaching our obligations under those free trade agreements.

Medium and Small Companies That Have 25% or More Overseas Ownership

The status quo

64 Non-large companies with 25% or more overseas ownership must prepare GPFR, but they have no filing obligations. They must appoint an auditor but can opt out if shareholders unanimously agree.

Recommendation and rationale

65 I consider that the GPFR preparation requirements should be removed. The creditor protection benefits referred to above in relation to large overseas-owned companies are not sufficiently great to justify retaining the filing requirement for medium and small companies. This would make the requirements for domestically-owned and overseas-owned small and medium companies fully consistent.

Overseas Incorporated Companies that Carry on Business in New Zealand

The status quo

66 As a general rule, this class of companies is required to prepare and file audited GPFR. They must file:

- Audited consolidated financial statements, where the legal entity is part of a group of companies.
- Audited financial statements for the legal entity; and
- Audited financial statements for the New Zealand business of the company as if it was a stand-alone entity.

67 The Registrar of Companies can provide exemptions for the legal entity financial statements where the home country only requires consolidated financial statements to be prepared, if the cost of producing the legal entity financial statements for New Zealand filing purposes would be onerous or burdensome. Class and individual exemptions have been made for United States companies.

Recommendations and rationale

68 The arguments in relation to this class of company are the same as for companies that have 25% or more overseas ownership. That is, if an overseas company carrying on business in New Zealand is large, then it should be required to file audited financial statements for creditor protection reasons. The existing requirement for non-large overseas incorporated companies to prepare should be removed.

69 The only other change I am recommending is to introduce a new approach for the legal entity financial statements. Those statements would need to be prepared and filed, but only if there is a preparation requirement in the home jurisdiction. This would mean that the Registrar's exemption power could be consequentially repealed.

70 The associated compliance cost savings would be small because only 1,575 overseas companies are registered and the saving per company would be small.

OTHER PRIVATE SECTOR FOR-PROFIT ENTITIES

Trading Trusts

Background and the status quo

71 Trading trusts are mainly established to combine the benefits of limited liability and obtain tax advantages through income splitting arrangements. Trading trusts have no financial reporting obligations.

72 The Law Commission is currently carrying out a review of the law of trusts in New Zealand. Financial reporting issues may arise, particularly in relation to the Commission's consideration of the legal environment for trading trusts.

Recommendations and rationale

73 None of the indicators of financial reporting apply. Hypothetically, the default should be no preparation but with a right to opt into preparation and assurance by the trustee company. In practice, the trustee can exercise this power without amending the law. Therefore, I am recommending no change.

Limited partnerships

Background and the Status Quo

74 Limited partnerships comprise general partners (who manage the business) and limited partners (who provide the capital). The general partners must prepare GPFR and disclose them to the other partners. Audit and publication are not required.

Recommendations and rationale

75 I recommend the following:

- a Consistent with the proposals for large non-issuer companies, large limited partnerships:
  - i Would not have filing requirements, for commercial confidentiality and privacy reasons;
  - ii Would continue to be required to prepare GPFR; and
  - iii Would have a new obligation to have an audit carried out by a chartered accountant or a licensed auditor.
- b Removal of the preparation requirement for non-large limited partnerships. Although the separation indicator invariably applies, the limited partners are able to demand the financial information they need as a condition of providing the capital.

Partnerships

The status quo

76 There are no financial reporting obligations under the Partnership Act 1908.

Recommendations and rationale

77 Large partnerships should be required to prepare GPFR, have them audited by a chartered accountant or a licensed auditor and distribute them to all partners. However, filing should not be required for commercial confidentiality and privacy reasons. This change would only apply to a very small number of partnerships (perhaps 20), mainly professional service providers. It would impose few if any compliance costs because large partnerships probably already prepare financial reports of the type that the standards setter is likely to require, and they will be having an audit completed.

78 I recommend no change in relation to partnerships that are not large, mainly because the separation indicator would rarely apply. Even where it does apply, the costs of enforcement would be disproportionately high because there is no register of partnerships or annual return requirement.

Sole traders

79 Sole traders have no financial reporting obligations. The status quo should be retained. Hypothetically, the economic significance indicator could apply to a sole trader business venture. However, it would seem very unlikely in practice, given the personal liability risks. The separation indicator never applies.

PRIVATE NOT FOR-PROFIT ENTITIES

Background

80 The not-for-profit sector is atomised, with the vast majority of entities being small or micro entities. To illustrate, about 45% of the 25,000 registered charities have annual expenditure of less than $20,000, 70% less than $100,000 and 95% less than $2 million (See Table Two).

81 The heavy emphasis towards smallness has significant implications for financial reporting. It means that most not-for-profit entities that should have preparation requirements should only be expected to produce basic reports in accordance with simple format templates.

Table Two: Size distribution for registered charities

Annual operating expenditure	Percentage	Cumulative percentage
≤ $10,000	35%	35%
$10-20,000	10%	45%
$20-30,000	7%	52%
$30-40,000	5%	57%
$40-50,000	4%	61%
$50-100,000	11%	72%
$100-150,000	5%	77%
$150-200,000	3%	80%
$200-500,000	10%	90%
$½-1 million	4%	94%
$1-2 million	2%	96%
$2-5 million	2%	98%
>$5 million	2%	100%

Source: Charities Commission, August 2010

82 The main financial reporting policy interest in the not-for-profit sector relates to entities that are publicly accountable. The test that needs to be applied to determine public accountability is whether the entity takes money directly from persons other than its members, and/or from funders that are able to demand the financial information they need (e.g. philanthropic organisations). If the entity does take money directly from other sources (e.g. in the form of donations), then there is a rebuttable presumption that it should be required to publish GPFR. This is needed to provide accountability for the effective and efficient use of the money to the donating public. Applying this test:

- Registered charities, credit unions and gaming machine societies are publicly accountable; and
- Some charitable trusts, industrial and provident societies, friendly societies, incorporated societies and unincorporated societies are publicly accountable, while others are not.

83 Each category is discussed below.

Registered charities

Background

84 Registered charities are exempt from income tax and certain other forms of tax. In addition, many registered charities also have donee status for the purpose of the Income Tax Act 2007. Donee status is administered by IRD. Charitable gifts to donee organisations are generally eligible for tax benefits. They amount to being subsidies from the government. However the conferment of tax benefits does not in itself create public accountability from a financial reporting perspective, as the purpose of financial reporting law is to provide access to financial statements for users who cannot demand them. There is no causal link between the tax benefit and the existence of such a class of user. However, public accountability arises if a donee organisation seeks donations from the public.

85 Charities are publically accountable because those who make donations and bequests should have access to information about whether the money or other assets they have gifted have been used effectively and efficiently. Other than philanthropic organisations, most donors do not have the bargaining power required to demand that information.

The status quo and problems

86 All registered charities must include financial information in their annual returns to the Charities Commission. They are required to complete a fill-in-the-box type form and file a set of financial statements. However, there are no standards to govern the filed information. Consequently, there is preparer uncertainty about what they should prepare and user uncertainty about the underpinning assumptions. In addition, many charities are still learning as they adjust to the new requirements imposed under the Charities Act 2005.

87 A study[5] that examined returns filed by 300 small and medium-sized registered charities, notes that a wide variety of formats and bases are being used for financial statement compilation. The lack of consistency reduces transparency and accountability because it is difficult to compare charities. Of the 212 that prepared on an accrual basis, 43 did not include an amount for equity, 5 failed to file an income and expenditure statement or a balance sheet or both, and fewer than 65% provided appropriate notes to enable the financial statements to be understood.

88 These findings suggest that much could be achieved with simple format reporting templates for small and medium-sized charities. The XRB is working with NZICA, the Charities Commission and other interested parties to develop templates.

[5] Cordery, Carolyn and Kapil Patel, *Financial Reporting Stocktake: An Assessment of Accountability through Charities' Filing on New Zealand's Charities Register,* Victoria University of Wellington, (unpublished) 18 March 2011.

89 Another study[6] suggests that there are also major issues with reporting by some larger charities. The three main conclusions were as follows:

a The knowledge of appropriate professional standards by accountants working in the charities sector is poor;

b There is a low level of financial literacy among preparers and users of charities' financial statements; and

c Many charities actively lower their assets to "look poor" as they seek to gain more funding.

90 The study also concluded that the accounting methods used appear to be unique to the charities sector and are inconsistent with the requirement in the NZICA Code of Ethics for neutrality and freedom from bias when preparing financial statements.

Recommendations and rationale

91 There are many causes of these problems and it is beyond the scope of this paper to deal with the broader capability issues. However, significant improvements can be achieved through the Financial Reporting Act and I am proposing two main changes.

92 First, the XRB would be empowered to set financial reporting standards for registered charities. This change would establish a consistent basis for reporting, thereby removing the proliferation of formats and reducing the use of different bases for compilation of the financial statements.

93 Second, a tiered approach would be adopted to reflect different costs of reporting and benefits to users depending on the size of the charity. Depending on other decisions that are yet to be made by the XRB, the reporting framework for not-for-profit entities might be as described in Table Three.

Table Three: Potential tiered reporting framework for not-for-profit entities

Annual Expenditure	Reporting basis
More than $2 million	Full GAAP-compliant reports
$40,000-$2 million	Simple format accrual reports[7]
$40,000 or less	Cash in/out simple format reports

[6] Sinclair, Rowena, *Understandability and Transparency of the Financial Statements of Charities*, PhD thesis, School of Business, Auckland University of Technology (2010).
[7] The XRB has advised that the simple format reporting will be similar to the existing simple format requirements for small companies that appear in the Financial Reporting Order 1993.

94 The main impact will be to generally improve the quality of financial reporting by registered charities. For example, the XRB would be able to address the 'off-balance sheet/looking poor' issues by requiring some or all large charities to prepare consolidated financial statements[8]. Generally improving the quality of reporting will benefit users and contribute to better governance of the entities.

95 The changes will also reduce costs for many of the 95% of registered charities that are not large because of the certainty of having simple templates that specify the preparation requirements in easily understood ways. This will save time for many of the thousands of non-accountant volunteers who carry out much of the preparation activity.

96 There will, however, be an increase in compliance costs for charities whose current reporting is inadequate. I consider that imposing these costs is justified. Inadequate filings (e.g. filing bank statements, as is the case with a small number) indicate that those charities are not keeping adequate accounting records or controlling their costs, and have little if any idea of their annual revenue and whether they are obtaining surpluses or incurring deficits. As noted above, I propose that these changes be implemented together with education and support materials developed in consultation with the sector, to help improve the quality of financial reporting and minimise the costs of transitioning to the new regime.

97 Some more specific impacts would be as follows:

- The largest 4% (with annual expenditure of $2 million or more) would file GAAP-compliant reports. Such a requirement is unlikely to have any significant cost or benefit implications because the majority of large registered charities are already preparing GAAP-compliant financial statements and having them audited, mainly due to requirements imposed by funding agencies and for internal governance reasons. The XRB may need to consider whether to require the preparation of consolidated financial statements by some large charities that are not currently consolidating. If so, some of those entities could incur potentially large additional compliance costs. However, the XRB will only impose such an obligation if there are outweighing benefits to users.[9]

- The next 40% (annual expenditure of $40,000 to $2 million) would be required to file accrual-based simple format reports. Many charities in this class already prepare accruals-based reports. However, the others that are using cash accounting will need to make minor changes to their systems in order to comply.

- The remaining 55% (annual expenditure of less than $40,000) would file cash-in/cash-out simple format reports. Cash reporting is less valuable than accrual reporting. However, many not-for-profit micro entities do not have the resources to engage people or find volunteers who understand accrual accounting principles. Satisfactory cash reporting is also an indication that adequate accounting records are being kept.

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[8] However, financial reporting cannot address the ethical and funders' mind set issues.

[9] The main benefit of consolidation is that it provides a sense of the overall scale of the charity and the resources at its disposal.

98 The XRB, NZICA and non-profit sector groups are working to develop simple reporting templates that will be freely available to help most non-profits prepare cash or accrual based financial statements.

Assurance for registered charities

99 An assurance engagement (i.e. an audit or review) is carried out by an independent person. The benefit that users of the financial statements obtain is a higher level of certainty that the financial statements are free from material error. There are no statutory obligations on registered charities to have an audit or a review engagement completed, but many do have them completed because their constitution requires it and/or funders require it as a condition of granting money.

100 There is no one-size-fits-all solution to the assurance issue. Most registered charities are very small and this means that the cost of assurance will exceed the benefits. At the other extreme, assurance is clearly of net benefit in relation to the small number of charities that spend several hundreds of thousands or millions of dollars a year. There is a need to set a dollar threshold somewhere between those extremes above which assurance would be required for registered charities. There is not enough information at present to determine what that amount should be. Therefore, I am proposing that officials be tasked with carrying out further consultation and analysis on the issue and report back. This work would start in 2012.

Entities registered under the Charitable Trusts Act 1957

Background and the status quo

101 The trustees of charitable trusts and charitable societies can choose to incorporate as a charitable trust board under the Charitable Trusts Act 1957. A trustee or society can only be incorporated as a charitable trust board if it exists principally for a charitable purpose or for any purpose that is religious or educational. Entities registered under the Charitable Trusts Act 1957 have no financial reporting or annual return requirements *per se*. However, charitable trusts that are registered charities must file financial information with the Charities Commission.

102 About 9,000 of the 20,000-odd registered charitable trusts are also registered charities (i.e. 45%). The remaining 11,000 charitable trusts can be categorised as follows:

a Trusts that seek donations from the public but choose not to register with the Charities Commission – The public accountability indicator applies;

b Trusts that are essentially private in nature because they do not seek donations from the public – The public accountability indicator does not apply; and

c Those that are no longer operating but remain on the register – It is likely that a significant number would fall into this category. Charitable trusts do not file an annual return and it seems likely that the Registrar would not be notified about trusts being wound up in a significant proportion of cases.

Recommendations and rationale

103 The Law Commission is currently reviewing the Incorporated Societies Act 1908. Its issues paper notes that there are two general statutes for the incorporation of not-for-profits in New Zealand (i.e. The Incorporated Societies Act 1908 and the Charitable Trusts Act 1957). The issues paper asks whether it might be better to have a single statute.

104 This question has the potential to raise issues about the broad statutory governance regime for not-for-profit entities. I consider that it would be better to not make decisions about financial reporting for charitable trusts that are neither registered charities, issuers nor economically significant before decisions are made about the more fundamental issues. The financial reporting issues can be addressed as part of the Government's response to the Law Commission's final report.

Incorporated societies that are not registered charities

Background

105 An incorporated society is a not-for-profit entity that is legally distinct from its members. Incorporated societies cover a wide range of activities including charitable activities, sport and recreation, music and culture and special interest activities. As at 31 March 2010, almost 30% of incorporated societies (6,671 out of 22,872) were also on the Charities Commission Register. Due to the tax and reputation benefits associated with being on that Register, it is reasonable to assume only a small proportion of the 16,200 incorporated societies that are not registered charities are publicly accountable.

The status quo

106 All incorporated societies are required to include basic fill-in-the-box information about income, expenses, assets, liabilities and equity in their annual returns to the Registrar of Incorporated Societies, but no assurance engagement is required. There are no financial reporting standards to govern what is submitted. Incorporated societies are not required to submit an annual return to the Registrar of Incorporated Societies if they are also registered charities.

Recommendation and rationale

107 For the reasons discussed in relation to charitable trusts, I am not recommending any financial reporting changes at this time for incorporated societies that are neither registered charities, issuers nor economically significant.

Industrial and provident societies that are not issuers

Background and status quo

108 Industrial and provident societies are bodies corporate with perpetual succession. The members are mainly owners of small businesses who, while operating independently, obtain benefits from being part of a mutual society (e.g. the economies of scale and scope that taxi proprietors obtain from being a member of a cooperative taxi society). Industrial and provident societies are required to file GAAP-compliant financial statements with the Registrar of Industrial and Provident Societies but are not required to have an audit carried out.

Recommendations and rationale

109 Although industrial and provident societies are not-for-profit entities, they exist for the purpose of fostering the commercial interests of their members. Most of them have more in common with for-profit businesses than, say, entities that participate in amateur sport, recreation, arts or cultural activities. They should be treated the same as for-profit entities for financial reporting purposes.

110 Application of the indicators of financial reporting leads to the conclusion that the filing requirement should only be retained for industrial and provident societies that are issuers or are economically significant. In practice this would mean that only one of the existing 300 or so societies would continue to be required to file financial statements.

111 The separation indicator applies to all industrial and provident societies. Therefore, the preparation, assurance and distribution defaults proposed for for-profit entities should apply, with opt-out being available and a requirement to file an annual return for register accuracy reasons.

Friendly societies

Background

112 Friendly societies mainly provide insurance-related benefits to members and their families, such as sickness and other medical benefits, annuities in old age, funeral benefits and life insurance. They operate on insurance principles and mutual sharing of risk, with benefits being paid from funds accumulated from the contributions of members. Other entity types can register as friendly societies, most notably:

- Benevolent societies, which provide similar types of benefits, but usually on a very small scale and with a lower degree of security; and
- Working men’s clubs – However, many working men’s clubs choose to register as incorporated societies.

113 There are about 165 registered societies which, in total, have about 940,000 members and total income of $566 million. These numbers are dominated by the Southern Cross Medical Care Society, with 835,000 members and income of $523 million in 2008/09.

The status quo

114 This group of entities is required to file simple format financial statements as part of their annual returns to the Registrar of Friendly Societies and Credit Unions. They must also have an audit completed if their receipts and payments both exceed $50,000.

115 The Registrar is required to examine the annual returns, with a particular emphasis being placed upon the auditors' reports and the solvency position of each entity. Wherever necessary, concerns raised by data contained in the annual returns are followed up by seeking further information and explanation. This monitoring role has effectively been a low cost substitute for prudential regulation.

Recommendation and rationale

116 The Insurance (Prudential Supervision) Act 2010 will introduce prudential regulation by the Reserve Bank for friendly societies that provide insurance services. The Registrar's monitoring role will become redundant once prudential regulation comes into force because:

- It will amount to unnecessary duplication for those societies that provide insurance services; and
- There is no need to monitor societies that do not provide insurance services.

117 Although the monitoring role should be removed, the filing requirement should be retained for societies that provide insurance services because they manage other people's money in a fiduciary capacity. There should also be a filing requirement for any non-insurance friendly societies that might be economically significant.

118 The separation indicator applies to all friendly societies and the default/opt-out proposals recommended for incorporated societies should also be adopted for friendly societies.

Credit Unions

Background and status quo

119 A credit union is a member-owned co-operative financial organisation that is set up to provide savings and loans facilities to its members. There are a small number of economically significant credit unions but most of them are very small by financial sector standards. All credit unions must file audited GAAP-compliant financial statements. The Registrar monitoring function outlined above in relation to friendly societies also applies to credit unions.

Recommendations and rationale

120 All credit unions are publicly accountable because they accept deposits. They should continue to be required to file audited financial statements. However, the Registrar's monitoring function should be removed because credit unions are now prudentially regulated by the Reserve Bank.

Gaming machine societies

Background

121 Gaming machine societies are licensed to operate gaming machines solely in order to raise money for authorised purposes. They typically take the form of an incorporated society, charitable trust, company, or an entity registered under the Friendly Societies and Credit Unions Act 1982.

122 Like other forms of authorised gambling, non-casino gaming machine societies are regulated by the Department of Internal Affairs (DIA) under the Gambling Act 2003. Regulation is needed primarily to control the growth of gambling and prevent and minimise harm resulting from gambling. Gaming machine profit (GMP), which is the gross amount obtained from gaming machine operations after prizes but before other expenses are deducted is a reasonable approximation of annual revenue.

123 There are two categories of gaming machine societies for regulatory purposes:

- Non-club societies, most of which operate machines almost exclusively in commercial venues – Of the 49 licensed societies, 15 generated GMP of greater than $10 million in the latest financial year. Total GMP for the six largest non-club societies was $356 million; and

- Club societies that operate machines almost exclusively in their own premises – Only 16 of the 334 clubs licensed to operate machines in 2009/10 generated GMP of more than $1 million.

The status quo

124 All gaming machine societies are required to submit the following financial information to DIA for regulatory purposes:

- Audited GAAP-compliant financial statements; and

- Statements of the distribution of gaming machine net proceeds (GMP minus expenses) to authorised community purposes.

125 Legal form determines whether a gaming society is required to make its financial statements public. Working men's clubs that are registered under the Friendly Societies and Credit Unions Act and incorporated societies have such requirements, while those that are charitable trusts and companies do not.

Recommendations and rationale

126 Producing audited GAAP-compliant financial statements is an integral part of the gaming machine regulatory system. The only remaining issue is whether they should be required to make the financial statements public. It is unsatisfactory that legal form, rather than economic substance, determines whether gaming machine societies have filing obligations for the purposes of being placed on a public register. The indicators of financial reporting point to the following:

- Societies that operate machines in commercial venues are publicly accountable and should be required to publish;
- Club societies that are economically significant should be required to publish. I am recommending that $30 million GMP be used as the threshold for determining economic significance, as this would approximate the $30 million of annual operating expenditure that is proposed for other not-for-profit entity types. No club societies currently meet or are likely to meet this threshold in the foreseeable future; and
- All club societies should be required to distribute the audited financial statements to members.

127 These proposals will not limit the regulation of gaming societies carried out by the Department of Internal Affairs.

Unincorporated societies

The status quo

128 Unincorporated societies only have financial reporting obligations if they are registered under the Charities Act.

Recommendation and rationale

129 The status quo should be maintained for the following reasons:

- Although some unincorporated societies that are not registered charities will be publicly accountable, the associated costs of identifying them and enforcing the reporting requirements would be disproportionately high.
- There are a small number of economically significant unincorporated entities (e.g. the Anglican Church). However, for the most part there are strong incentives for societies to incorporate when they start becoming large because members are personally liable for the debts.
- Although the separation indicator is likely to apply to the great majority of unincorporated societies, again the enforcement costs would be disproportionately high.

ENTITIES THAT MAY BE FOR-PROFIT OR NOT-FOR-PROFIT

Retirement Villages

The status quo

130 Retirement villages are regulated for the purposes of protecting the interests of the residents, including protecting their investments in retirement village units. They are required to file audited GPFR as part of their annual return to the Registrar of Retirement Villages. Those villages that are required to have a statutory supervisor must also supply the GPFR to the supervisor, who uses them for monitoring purposes.

131 Retirement villages are included in the definition of "issuer" in the FRA, but not in the Securities Act definition. This means that they are all treated as though they are issuers for financial reporting purposes even though most are not issuers in a real sense.

Recommendations and rationale

132 Producing audited GAAP-compliant financial statements is an integral part of the retirement village regulatory system. Therefore, the preparation and audit requirement should be retained and the financial statements should be distributed to residents.

133 The current approach of deeming retirement villages to be issuers under the FRA when some are not issuers in substance is problematic. This inapt definition has created a problem for the standards setters because their practice is to place all issuers in the top tier of reporting (i.e. compliance with the New Zealand equivalents of International Financial Reporting Standards), based on the not unreasonable assumption that they are all publicly accountable. This means that most villages incur excessive compliance costs because, compared with Tier Two (which is the tier they would otherwise be in), some measurement methods are more complex, the number of disclosures is considerably higher and there are impairment testing requirements for some classes of fixed assets (which means that independent valuations must be obtained annually).

134 I am therefore recommending the following for retirement villages:

- To continue to require all retirement villages to prepare assured GPFR and to distribute them to residents;
- To remove retirement villages from the definition of issuer in the FRA;
- To treat villages which are issuers in a real sense or large in the same way as other publicly accountable and/or large entities (i.e. to file audited financial statements with the Registrar of Companies); and
- Non-issuer villages would be required to prepare GPFR in accordance with the requirements of the tier of reporting to which they are allocated, have them audited and distribute them to residents.

MĀORI ASSET GOVERNANCE ENTITIES

135 The forms of governance entities that are available for certain Māori assets are:

a Māori trust boards; and

b Te Ture Whenua Māori Act (TTWMA) entities comprising:

i Māori reservations;

ii Maori incorporations; and

iii Māori land trusts.

136 Many Māori asset governance entities are registered charities. Therefore, they are required to comply with the reporting requirements imposed under the Charities Act 2005.

Māori trust boards

Background

137 The Māori Trust Boards Act 1955 is generally suited to hapū and iwi whose main objectives are political, social and cultural or for holding assets that are unlikely to be sold. The main function of a board is to administer the assets for the general benefit of the beneficiaries. They are permitted to provide money for the benefit or advancement of any class or classes of beneficiary or any individual beneficiary. For example, money can be used to promote health, education and vocational training.

The status quo

138 At present Māori trust boards are accountable to the Minister of Māori Affairs, including in relation to financial reporting matters. However, Cabinet decided in 2009 to provide direct accountability by boards to the beneficiaries. Under the proposed changes, boards will be required to prepare audited GPFR and distribute them to the beneficiaries. The changes are included in the Māori Purposes Bill, which is due to be reported back by the Māori Affairs Select Committee by 16 May 2011.

Recommendations and rationale

139 The policy approved by the Government in 2009 is consistent with the indicators of financial reporting. Therefore, no further changes are needed.

Māori reservations

Background

140 The TTWMA provides scope for a Māori reservation to be established over both Māori freehold land and general land. Typically, reservations are set aside over land that is culturally, spiritually or historically significant to Māori (e.g. marae, church sites and sports grounds). The land within a designated Māori reservation is inalienable while the reservation subsists. The main function of the trustees is to administer the reserve for the beneficiaries, usually a hapū.

The status quo

141 The Māori Reservations Regulations 1994 require the trustees to maintain up-to-date records and accounts. However, there are no requirements to prepare financial statements.

Recommendations and rationale

142 I recommend retention of the status quo. Māori reservations are not publicly accountable and are never economically significant. They do not usually generate revenue and, if they do, the amounts are usually very low. There would seem to be little value in requiring them to prepare GPFR even though the separation indicator applies.

Māori incorporations

Background

143 The Māori Land Court can constitute a Māori incorporation over one or more blocks of Māori freehold land provided that at least one of the blocks has more than two owners. The Court fixes the number of shares and allocates them to the owners and trustees. The shareholders elect a committee of management. Māori incorporations have similar powers to companies, although there are restrictions on the alienation of shares.

144 There are about 150 Māori incorporations. A small number are economically viable farms, but most hold very small areas of land. In addition, the Māori land trust model (see below) is preferred because the governance system is much simpler. I understand that:

- No new Māori incorporations have been formed in the last four or five years; and
- Five or so incorporations have been reconstituted as Māori land trusts in the last two or so years.

The status quo

145 Māori incorporations have the following financial reporting requirements:

- To prepare statements of financial position and performance;
- To have an audit completed by a chartered accountant or a member of an association of accountants constituted in a Commonwealth country which has been approved by the Minister of Commerce (none have been approved, to our knowledge); and
- To file the financial statements with the Māori Land Court Registrar – The Registrars do not operate public registers and the financial statements are treated as confidential to shareholders.

146 Many small Māori incorporations do not comply with the current preparation and filing obligations.

Recommendations and rationale

147 The economic significance indicator applies to a very small number of Māori incorporations but commercial confidentiality and privacy issues arise and there should be no public filing requirement. However, large incorporations should be required to prepare GPFR, have them audited and distribute them to the beneficial owners that appear on the register of owners held by the Māori Land Court.

148 As at June 2009 there were, on average, 88 beneficial owners per title of Māori land. Hypothetically, the default position should be to require preparation, assurance and distribution to the beneficial owners with the owners having the ability to opt out. However, we are not recommending opt-out. It is very unlikely to work in practice due to the lack of incentives to participate in meetings of the incorporation. There is little incentive to vote if one has, for example, a five per cent ownership interest in two hectares of land.

149 The requirement to file financial statements on the basis that they are confidential to the shareholders should be retained. This is, in the circumstances, the most efficient way of ensuring that the beneficial owners have access to the financial statements, because the compliance costs of distribution to all owners would be disproportionate for small incorporations.

150 I am however, recommending changes in relation to assurance. For the same cost-benefit reasons discussed in relation to not-for-profit entities, I consider that:

- Small incorporations should not have any assurance obligations; and
- Medium-sized incorporations should be able to have a review carried out as an alternative to an audit.

Māori land trusts

Background

151 Part 12 of the TTWMA provides for five categories of trust for Maori freehold land, as follows:

- Ahu whenua trusts manage whole blocks of Māori freehold land. They are sometimes used for commercial operations and are the choice of trust for farming operations on Māori freehold land. There are about 5,500 ahu whenua trusts;
- Whenua tōpū trusts manage land belonging to an iwi or hapū. They share many of the features of Ahu whenua trusts;
- Whānau trusts manage the beneficial interests or shares in Maori land or general land owned by Māori. They enable whānau members to bring together all of their interests or shares for the benefit or advancement of the whānau and the descendants of the tipuna named in the trust order;
- Kai tiaki trusts manage land interests and personal property of minors or disabled persons who are unable to manage their affairs; and
- Pūtea trusts manage non-economic small share interests within a block or blocks of land. The shares and any income they produce are held for Maori community purposes.

152 Although there is a list of owners for every block of land, many lists are out of date because some individuals who could claim ownership rights in relation to individual blocks of land have not succeeded to their share entitlement. In addition, many land owners have no known contact details.

The status quo and the problem

153 The Māori Land Court has exclusive jurisdiction to constitute Māori land trusts. The governance accountabilities are established through trust orders of the Court that set out the terms of the trust, including making such provisions it considers necessary or desirable in relation to financial record keeping, inspection and auditing of the accounts of the trust. The Court can also approve provisions for the annual reviewing of trust financial records. The trust deeds tend to only define what has to be prepared, without specifying whether they need to be GAAP-compliant.

154 Trusts may be reviewed from time to time to deal with a problem, make improvements or to reflect changing circumstances. The review can be initiated by an owner or trustee by making application to the Court or on the Court's own volition. There is no formal mechanism for ensuring consistency of approach in financial reporting matters except to the extent that the court considers consistency to be important when exercising its discretionary powers.

Recommendations and rationale

155 Māori land trusts are diverse, both in terms of their purposes and their size. Applying the indicators of financial reporting leads to the following conclusions:

- There are no public accountability issues;
- Potentially, a very small number of Ahu Whenua, Whenua Topū and Whānau trusts could be economically significant. There are no economic significance issues in relation to Kai Tiaki and Pūtea trusts. Economically significant trusts should be required to prepare GPFR and have an audit carried out by a chartered accountant or a licensed auditor; and
- The average of 88 beneficial owners per title to Māori land hypothetically implies a default position to require preparation, assurance and distribution to the beneficial owners with the ability to opt out of assurance or preparation. However, this would be no more practical for Māori land trusts than for Māori incorporations.

156 However, there is a workable solution. The reporting requirements for Māori land trusts should, as far as possible, be consistent with the reporting system for not-for-profit entities that are not publicly accountable but with the Māori Land Court having the power to vary those requirements to meet individual circumstances. This would mean, in effect, that the Court would continue to exercise its role as the overseer of Maori land trusts.

157 The default preparation requirements, if the XRB sets the tiers of reporting at the levels it identified in a discussion document in 2009 would be as follows:

- Large trusts (annual operating expenditure of $2 million or more): Preparation in accordance with GAAP, audit and distribution to the known beneficial owners; and
- Medium and small ($40,000-$2 million): Preparation in accordance with the simple accrual format and distribution.

158 Māori land trusts that have annual operating expenditure of $15,000-$40,000 would be required to prepare in accordance with the simple cash format and distribute them to the beneficial owners, subject to variation by the Māori Land Court. However, those below $15,000 would have no distribution requirements because the costs of distribution are likely to be greater than the negligible benefit that some owners might obtain.

CONSULTATION

159 The Ministry of Economic Development and the Accounting Standards Review Board simultaneously released discussion documents on the financial reporting framework in September 2009. MED received 151 submissions on its discussion document.

160 Following the request from EGI in May 2011, there was consultation with the following stakeholders:

a Credit managers and controllers within the main trading banks, and the New Zealand Credit & Finance Institute about the impact on creditors – They expressed support for retaining the GPFR requirements for small and medium-sized companies;

b BusinessNZ and NZICA on the impacts on creditors and business growth and creditors – Both organisations agree with the conclusions reached in this paper on those issues.

161 The Treasury, Inland Revenue Department, Ministry of Justice, Ministry of Foreign Affairs and Trade, Department of Internal Affairs, Department of Building and Housing, Te Puni Kokiri, Statistics New Zealand, Office of the Community and Voluntary Sector, SPARC, Securities Commission, Reserve Bank, Registrar of Companies, Charities Commission, Māori Trustee, Māori Land Court, Office of the Auditor-General and the Accounting Standards Review Board have been consulted on the contents of this paper. The Department of Prime Minister and Cabinet has been informed.

FISCAL IMPLICATIONS

162 There are no fiscal implications.

ADMINISTRATION IMPLICATIONS

163 The development and implementation of SPFR for tax purposes will have the administrative implications that are discussed in paragraphs xx-xx.

HUMAN RIGHTS AND PRIVACY IMPLICATIONS

164 The proposals contained in this Cabinet paper appear to be consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

LEGISLATIVE IMPLICATIONS AND IMPLEMENTATION

165 The changes proposed in this paper can only be implemented by way of primary legislation. The 2011 Legislation Programme includes a Financial Reporting Amendment Bill, which has a Category 5 priority, drafting instructions to PCO in 2011.

166 The target date for enactment is late 2012 or early 2013. The provisions would be brought into effect at different dates depending on the transitional issues for each class of preparer and, in the case of small and medium companies, when Inland Revenue has its replacement special reporting regime in place.

167 As noted in several places elsewhere in this paper, the XRB is developing simple format templates for use in the not-for-profit sector and there will be an education campaign to support these changes.

REGULATORY IMPACT ANALYSIS

Regulatory impact analysis requirements

168 The regulatory impact analysis (RIA) requirements apply to the proposals in this paper. A RIS has been prepared and is attached.

Quality of the impact analysis

169 The Regulatory Impact Analysis Team (RIAT) has reviewed the RIS prepared by the Ministry of Economic Development and associated supporting material, and considers that the information and analysis summarised in the RIS meets the quality assurance criteria.

Consistency with the Government statement on regulation

170 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 "Better Regulation, Less Regulation".

PUBLICITY

171 The changes proposed in this paper will have significant impacts on some classes of entities, notably small and medium companies. There will also be some impact on registered charities. I propose to issue a media statement.

172 The Ministry of Economic Development will publicise the decisions in its monthly newsletter and, subject to Recommendation 59, will place this paper on its website.

RECOMMENDATIONS

I recommend that the Committee:

Public sector entities

1 **Agree** to retain the requirements on all central and local government entities to make audited general purpose financial reports (GPFR) available to the public;

Issuers

2 **Agree** to retain the requirement on all issuers to file audited GPFR with the Registrar of Companies;

For-profit entities which are not publicly accountable but are large

3 **Note** that the accompanying secondary issues paper proposes that a for-profit entity would be regarded as economically significant (i.e. large) if it meets one or both of the following criteria:

3.1 Annual revenue of $30 million or more;

3.2 Total assets at balance date of $60 million or more;

Large companies

4 **Agree** that large companies and other large for-profit entities will be required to prepare GPFR and have them audited by a licensed auditor, chartered accountant or approved overseas person;

Medium and small companies

5 **Note** that all companies are currently required to prepare GPFR;

6 **Agree** to replace the current requirement on all non-large companies to prepare GPFR with the following:

6.1 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 for shareholders to opt out of assurance or preparation;

6.2 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;

7 **Agree** that opt-out and opt-in for preparation and assurance by company shareholders would operate as follows:

7.1 Assurance, or assurance and preparation would be able to be opted out of if shareholders representing no less than 95% of the voting shares who choose to vote agree to the motion;

7.2 Preparation, or preparation and assurance would be able to be opted into if shareholders representing no less than 5% of the voting shares who choose to vote agree to the motion;

8 **Agree** that non-large companies that would no longer have an obligation to prepare GPFR shall prepare simplified accrual-based special purpose financial reports (SPFR) for tax purposes under the Tax Administration Act 1994;

9 **Note** that it will take the Inland Revenue Department at least 18-24 months from the time Cabinet makes a decision on this matter to develop and implement the new requirements under the Tax Administration Act;

10 **Note** that IRD would be likely to take the opportunity to introduce SPFR requirements for other non-corporate business taxpayers at the same time;

11 **Agree** that the GPFR requirements would not be removed until the new Tax Administration Act requirements are in place;

12 **Note** that directors are required to have regard to the company's latest GPFR when making solvency-test-related decisions (e.g. distributions to shareholders);

13 **Agree** that the obligation on directors to have regard to GPFR in relation to solvency test-related decisions be changed, for companies that are not issuers and not large, to financial statements that are relevant in the circumstances;

Overseas companies

14 **Note** that, once implemented, any reductions in the current additional reporting obligations imposed on overseas-owned or overseas-incorporated companies will not be able to be reversed, due to New Zealand's obligations under various free trade agreements;

Overseas-owned companies

15 **Agree** to the following for companies that have 25 percent or more overseas ownership:

15.1 Retain the requirement on large companies to file audited GPFR, if the company is large, and that the audit be conducted by a licensed auditor, chartered accountant or approved overseas person;

15.2 Consistent with the proposals for New Zealand-owned companies, remove the GPFR preparation requirements if the company is not large but apply the 10 shareholder default and opt-out or opt-in rules;

Overseas-incorporated companies

16 **Agree** to the following for overseas-incorporated companies that carry on business in New Zealand:

16.1 Retain the requirement to file audited GPFR if the company is large and that the audit be conducted by a licensed auditor, chartered accountant or approved overseas person;

16.2 Remove the filing, audit and GPFR preparation requirements for overseas-incorporated companies that are not large;

17 **Agree** that the preparation rules for an overseas-incorporated company that is a reporting entity will be as follows:

17.1 To prepare consolidated financial statements;

17.2 To prepare the entity financial statements, but only if there is a requirement to prepare those statements in the home jurisdiction;

17.3 To prepare financial statements for the New Zealand business as though it were a stand-alone entity;

Other classes of for-profit entities

18 **Agree** that trading trusts will continue to have no GPFR obligations;

19 **Agree** the following in relation to large limited partnerships:

19.1 Retain the GPFR preparation and distribution obligations;

19.2 Add a requirement to have an audit conducted by a licensed auditor, chartered accountant or approved overseas person;

20 **Agree** to remove the GPFR preparation and distribution requirement for non-large limited partnerships;

21 **Agree** the following in relation to partnerships:

21.1 To require large partnerships to prepare GPFR, have them audited by a licensed auditor, chartered accountant or approved overseas person and distribute them to all partners;

21.2 Non-large partnerships will continue to have no GPFR obligations;

22 **Agree** that sole traders will continue to have no GPFR obligations;

Not-for-profit entities generally

23 **Agree** that the External Reporting Board (XRB) be empowered to make financial reporting standards for all not-for-profit entities that are required to prepare GPFR or simple format reports;

24 **Note** that reporting templates and guidance material will be developed and implemented to help minimise the costs of the new regime for charities and non-profit organisations and to help them transition to the new financial preparation and reporting requirements;

Not-for-profit entities which are publicly accountable

25 **Agree** that the following classes of entities will be treated as being publicly accountable:

25.1 Registered charities;

25.2 Friendly societies that provide insurance services;

25.3 Credit unions;

25.4 Societies that operate gaming machines in commercial venues;

26 **Agree** that there will be a tiered reporting system for publicly accountable not-for-profit reporting entities as follows:

26.1 Entities that have annual expenditure of less than $40,000 will be required to file simple format cash-in/cash-out financial statements;

26.2 Entities that have annual expenditure of $40,000 or more will be required to file financial statements that are, depending on entity size, prepared in accordance with a simple accrual accounting format or generally accepted accounting practice (GAAP);

27 **Note** that the XRB is considering a tiered approach which, depending on decisions that are yet to be finalised, could mean, in combination with the statutory requirements proposed above, that publicly accountable not-for-profit entities with annual expenditure of:

27.1 Less than $40,000 would be required to file simple format reports prepared on a cash-in/cash-out basis;

27.2 $40,000 to $2 million would be required to file reviewed simple format reports prepared in accordance with accrual principles;

27.3 $2 million or more would be required to file audited GAAP-compliant GPFR;

28 **Invite** the Minister of Commerce to report to EGI on the possible need for assurance for financial statements prepared by larger registered charities by 30 September 2012;

Not-for-profit entities which are large but not publicly accountable

29 **Note** that the test of economic significance proposed for not-for-profit entities in the accompanying secondary issues paper is annual operating expenditure of $30 million or more;

30 **Agree** that large not-for-profit entities will be required to file audited financial statements, with the audit being conducted by a licensed auditor, chartered accountant or approved overseas person;

Not-for-profit entities which are not registered charities or large

Incorporated societies and charitable trusts

31 **Note** that the Law Commission is carrying out a first principles review of the Incorporated Societies Act 1908 and that review could also impact on the Charitable Trusts Act 1957;

32 **Agree** to not make any changes to the financial reporting obligations for incorporated societies and charitable trusts that are not registered charities or large at present;

33 **Note** that the financial reporting implications will be considered in the Government's response to the Law Commission's report;

Industrial and provident societies

34 **Note** that although industrial and provident societies are not-for-profit entities, they tend to have more in common with for-profit entities due to their business orientation and members having an ownership stake;

35 **Agree** that financial reporting obligations for industrial and provident societies be generally consistent with those for companies;

Gaming machine societies

36 **Agree** that gaming machine societies that operate machines exclusively or almost exclusively in their own premises will be required to distribute audited GPFR to members;

37 **Note** that this change will not limit the regulation of gaming machine societies carried out by the Department of Internal Affairs;

Unincorporated societies

38 **Note** that some unincorporated societies are publicly accountable while others are not;

39 **Agree** that unincorporated societies that are not registered charities will continue to have no financial reporting requirements;

Friendly societies that do not provide insurance services

40 **Agree** that the financial reporting obligations for friendly societies that do not provide insurance services will consistent with those for incorporated societies;

Monitoring friendly societies and credit unions

41 **Note** that the Registrar of Friendly Societies and Credit Unions is required to monitor and report on friendly societies and credit unions but that the monitoring has become redundant due to the introduction of prudential regulation;

42 **Agree** that the monitoring and reporting function be removed;

Retirement villages

43 **Note** that all retirement villages will continue to be required to prepare and distribute assured GPFR to residents for industry-specific regulatory purposes;

44 **Agree** to require villages that are issuers in a securities law sense to file audited GPFR and that the audit be conducted by a licensed auditor;

45 **Agree** to require villages that are large, but not issuers in a securities law sense, to file audited GPFR and that the audit be conducted by a licensed auditor, chartered accountant or overseas-qualified person;

Māori asset governance entities

Maori trust boards

46 **Note** that financial reporting changes included in the Maori Purposes Bill include changes that are consistent with the indicators of financial reporting;

Māori reservations

47 **Agree** that Māori reservations will continue to have no financial reporting obligations;

Māori incorporations

48 **Note** that Māori incorporations are required to prepare financial statements, have them audited and file them with the Māori Land Court;

49 **Agree** to retain the status quo, with the exception of making the assurance engagement requirements consistent with those proposed for not-for-profit entities (i.e. to permit review as an alternative to audit for small incorporations);

Māori land trusts

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

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

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

53 **Agree** that, consistent with its role of overseer of Māori land trust deeds, the Maori Land Court will be able to make exceptions to the default requirements.

Legislation

54 **Note** that the 2011 Legislation Programme includes a Bill with priority 5 (Drafting instructions to PCO in 2011);

55 **Invite** the Minister of Commerce to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above recommendations;

56 **Authorise** the Minister of Commerce to make changes, consistent with the policy framework in this paper, on any issues that arise during the drafting process;

Publicity

57 **Note** that the Minister of Commerce will issue a press release on the main elements of Cabinet's decisions; and

58 **Agree** that the Ministry of Economic Development post a copy of this paper on its website.

Hon Simon Power
Minister of Commerce

Date signed: ______________________

APPENDIX ONE: ACCOUNTING JARGON AND CONCEPTS

Generally Accepted Accounting Practice (GAAP), General Purpose Financial Reporting/Reports (GPFR) and Special Purpose Financial Reporting/Reports (SPFR)

1 GAAP is predominantly the set of financial reporting standards issue by the External Reporting 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.

2 GPFR is financial reporting that is carried out in accordance with GAAP. 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.

3 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.

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

5 Any entity classes that are required to produce GPFR when there are special purpose users only are probably incurring unnecessary compliance costs because they will be disclosing some information that the special purpose users do not need. More disclosures mean more ledger accounts, every one of which needs to be reconciled. The added disclosures can also consequentially increase the complexity and cost of an audit. This is also the case for entities that have no external users and only need financial information for internal governance purposes.

Accrual accounting and cash-in/cash-out accounting

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

- Revenue received for goods and services in advance must 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 life of the asset.

7 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 few if any assets or liabilities with an economic life of more than one year. However, if these conditions do not apply, then cash-based statements are likely to be misleading because they may mistakenly treat assets as expenses and liabilities as revenues.

Reasonable and limited assurance

8 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 on whether the financial statements are prepared, in all material respects, in accordance with GAAP. 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.

9 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