

Accounting Alert

Special Edition

Analysis of the latest financial developments

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MED Discussion Paper :
The Financial Reporting Structure

Review of the Financial Reporting Act 1993

The Ministry of Economic Development has released a discussion document entitled *Review of the Financial Reporting Act 1993, Part I: The Financial Reporting Structure*.

The discussion document is the first part of a two-part review of the Financial Reporting Act 1993 (FRA) and deals specifically with the question of "who is required to report?"

The discussion document addresses four key areas:

1. Which entities should be required to comply with financial reporting requirements and what possible exemptions or relief should be available
2. The requirements for audit and filing of financial reports and whether these should be on a similar basis to the reporting requirements
3. Consideration of 'entity neutrality' and the possibility of having one set of financial reporting standards with universal application to all types of entity.
4. Consideration of 'sector neutrality' and the applicability of financial reporting standards to both profit oriented entities and "public benefit" entities, including governmental agencies and not-for-profit entities.

The Review

The discussion paper outlines a proposal put forward by the Accounting Standards Review Board (ASRB) for a new financial reporting framework. The document focuses on the specific needs of New Zealand entities and the users of the reports, with particular emphasis on eliminating unnecessary compliance costs unless they can be justified and there is a net benefit. The Ministry of Economic Development is seeking written submissions on the proposal and the issues raised in the document. The closing date for submissions is **Friday, 14 May 2004**.

For a copy of the discussion paper refer to the Ministry of Economic Development's website at www.med.govt.nz.

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The Proposed Financial Reporting Framework

The ASRB's proposal is for a three tier framework. This framework would replace the current three tier framework which arises under the FRA and which comprises:

- full reporting for certain entities which do not qualify for differential reporting under the Framework for Differential Reporting issued by the Institute of Chartered Accountants of New Zealand (ICANZ);
- differential reporting for those entities which are qualifying entities under the differential reporting framework; and
- limited reporting for those companies which fall within the exempt companies regime.

The current legislative framework only applies to certain entities which are required to report under the FRA or other specific legislation.

The basic premise of the proposed framework is that there should be one framework for all entities and the benefits of reporting should outweigh the costs. In order to make this latter assessment, it is necessary to find surrogate measures since measuring the benefits in dollar terms is not possible. This approach is similar to that found in the *Framework for Differential Reporting*.

The proposal identifies four proxies:

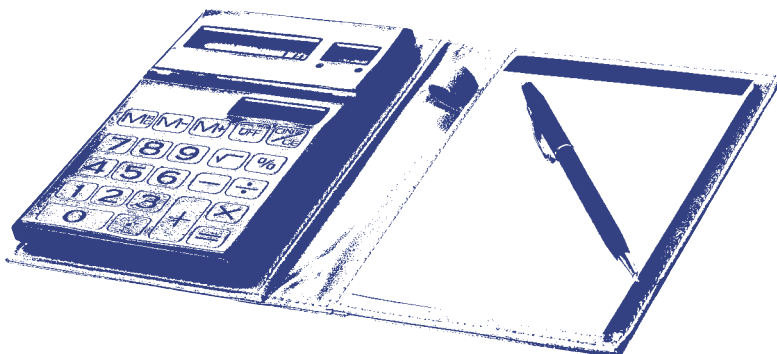
- 1) The status of the entity as an "issuer" or otherwise;
- 2) The coercive power to impose taxes, rates or levies;
- 3) A responsibility to report; and
- 4) Size

The first two proxies are similar to those found in the Framework for Differential Reporting. In relation to "a responsibility to report", an entity will have reporting responsibilities if its:

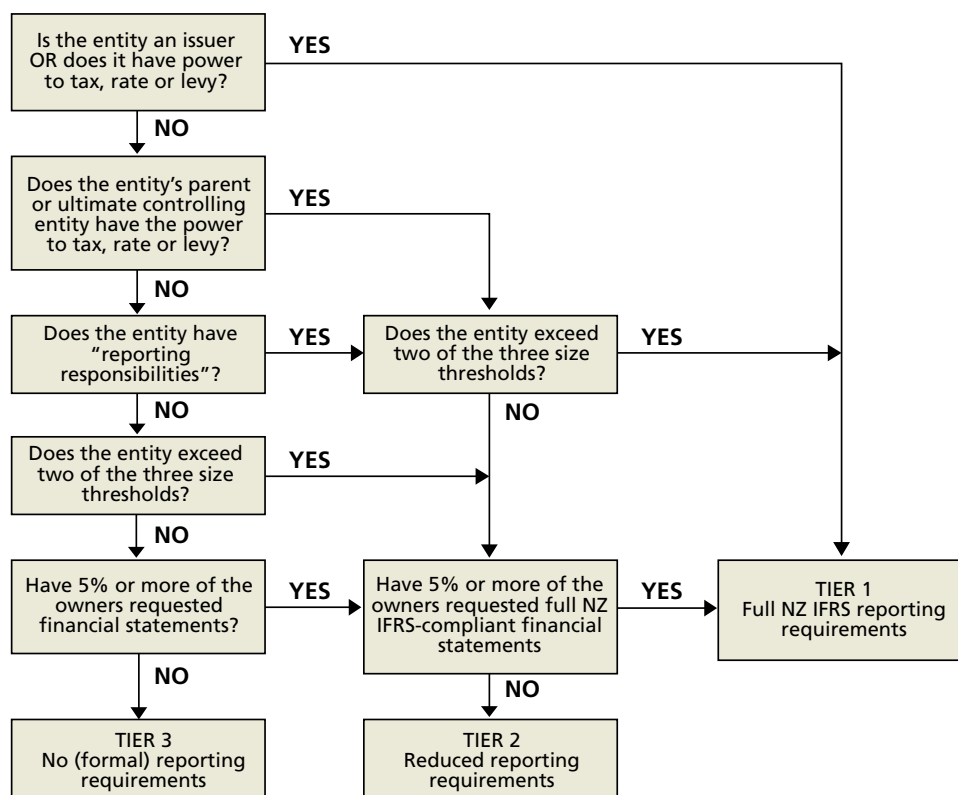
- Constitution or governing legislation requires reporting to the public (or a public official)
- Office holders are accountable to the public (e.g. clubs or member-owned entities)
- Elected officers are, or are analogous to, trustees
- Purpose is a charitable purpose (as approved by the IRD)
- Ownership is "foreign" (as defined in the FRA)
- Ownership and management are separate

An entity would be "large" if it exceeds two of the following:

- More than \$5 million in assets;
- More than \$10 million in reserves; and
- More than 20 full-time equivalent employees.



Below is an illustrative example of the proposed financial reporting framework reproduced from the discussion document:



Tier 1

Tier 1 entities would be required to comply with the full reporting requirements for New Zealand International Financial Reporting Standards (NZ IFRS). Tier 1 would include:

- issuers;
- entities with the coercive power to tax, rate or levy;
- large entities in the public sector;
- large entities with reporting responsibilities; and
- entities where more than 5% of owners request full reporting.

Tier 2

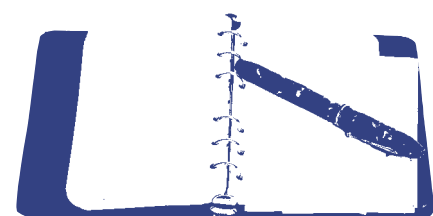
Tier 2 entities would also be required to produce reports, but with some relief from the full disclosure requirements. Tier 2 entities would include:

- small public sector entities;
- small entities with reporting responsibilities,
- large entities without reporting responsibilities; and
- Tier 3 entities where 5% or more of the owners, shareholders or stakeholders request financial statements.

This would include entities such as schools, clubs and large closely held companies.

Tier 3

Tier 3 entities would have no formal reporting requirements beyond the Companies Act requirements unless 5 % or more of the owners, shareholders or stakeholders request financial statements. Typically tier 3 companies would include all entities that are owned by





or represent only a few people.

The ASRB has floated the idea of the ASRB or ICANZ producing a "best practice" guide which would be similar to the current requirements for exempt companies.

Auditing and Filing Requirements

The discussion document addresses the concept that benefits produced from the entity having their financial reports audited and filed should outweigh the compliance costs involved. For example the audit of a smaller business would produce fewer benefits and impose a greater burden.

The Ministry of Economic Development's tentative view on auditing and filing requirements is as follows:

- All tier 1 entities' financial reports should be audited and filed;
- Tier 3 entities should be exempt from any audit and filing requirements.

In regards to Tier 2 entities, the Ministry has suggested that they should be subject to the full audit and filing requirements as for Tier 1 entities, since the rationale for producing financial reports also supports this. It is seeking comment in this regard.

Entity Neutrality and Sector Neutrality

The framework outlined above proposes that New Zealand should have a uniform financial reporting regime that encompasses all forms of entity and a sector neutral¹ standard setting environment. The Ministry is specifically seeking comment on these proposals.

General

A copy of the discussion paper can be found on the Ministry of Economic Development's website at www.med.govt.nz.

Submissions on the paper are due Friday 14 May 2004.

¹ In a sector neutral environment, the same financial reporting standards apply to all entities regardless of whether there is a profit motive or not.

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