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# Special Alert

5 October 2009

The big overhaul –  
the future of financial  
reporting in New Zealand

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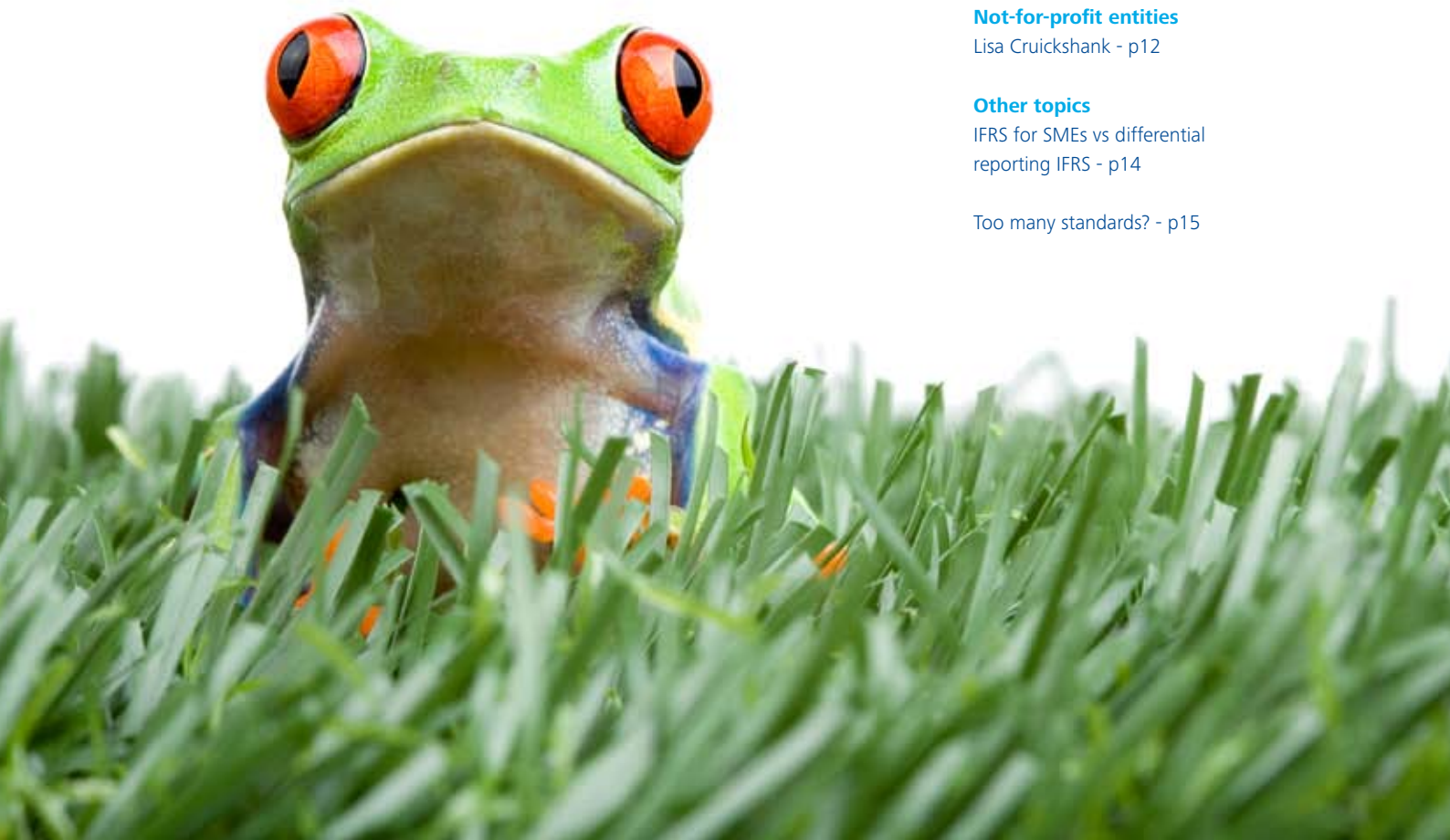
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# Introduction



This review is the most comprehensive attempt to update New Zealand financial reporting requirements yet. It is a significant undertaking and there are challenges to make sure New Zealand “gets it right” for all entities. If ultimately adopted, even in modified form, the recommendations will materially change the landscape for financial reporting, making it more logical and with greater alignment with Australian requirements.

Many small companies will be relieved of legislated financial reporting requirements, although not, of course, of the responsibility to keep proper accounting records. The Inland Revenue Department is one organisation that will continue to be interested in receiving company accounts.

However, not-for-profit entities such as charities, and large for-profit entities that are not companies, such as partnerships and incorporated societies, will find themselves now subject to the financial reporting and audit regime and some would ask why?

Perhaps controversially the paper also proposes to require large privately held companies to file audited financial statements, although existing entities may be grandfathered. This follows the Australian approach but is certain to run into opposition here.

The tiered reporting proposals seem to make general sense although SOE’s and local government trading entities should be unequivocally using IFRS and not a shortened version of IFRS.

The proposed statutory framework will affect most entities. In particular, if you are a privately held company, partnership, not-for-profit entity, or small public sector entity such as a school we would encourage you to consider its contents and how it could affect your organisation. The proposals in the papers are open for discussion and a number of questions are set out within them that affected entities should be discussing – they are not a fait accompli and we would encourage you to make sure your voice is heard. Submissions are due in by 29 January 2010.

The discussion document **The Statutory Framework for Financial Reporting** is available on the Ministry of Economic Development’s website.

The companion discussion document **Proposed Application of Accounting and Assurance Standards under the Proposed New Statutory Framework for Financial Reporting** is available on the Accounting Standards Review Board’s website.

**Murray Jack**  
CEO, Deloitte



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If you are a privately held company, partnership, not-for-profit entity, or small public sector entity such as a school we would encourage you to consider its contents and how it could affect your organisation

# Overview of the proposed statutory framework for financial reporting

**New Zealand is at a crossroads – the time has come to make some key decisions about the future of financial reporting in New Zealand amidst cries that IFRS is just too big for many NZ entities, criticisms that IFRS which is developed solely for for-profit entities is not appropriate for public sector and not-for-profit entities, and the recognition that it is time to line up with other major jurisdictions to bring the standard setting functions for both accounting and auditing standards out from under the profession's control to reside in an independent body.**

New Zealand's current financial reporting regime is an ad hoc set of requirements for different entities that has evolved over the last century. Some entities such as Incorporated Societies are still subject to requirements that have not changed since 1908! The Financial Reporting Act 1993 (FRA) together with the Companies Act 1993 introduced more comprehensive requirements but only for companies and issuers. There are no reporting requirements specified in legislation for a number of entities such as charities. Standard setting in New Zealand has also been slightly curious with the ASRB the government appointed body only able to approve rather than set accounting standards.

In recognition of this unsatisfactory environment, the Ministry of Economic Development (MED) has undertaken a review and issued a discussion document entitled *The Statutory Framework for Financial Reporting* which outlines its tentative proposals for the future of financial reporting in New Zealand. It is accompanied by a companion discussion document issued by the Accounting Standards Review Board

(ASRB) entitled *Proposed Application of Accounting and Assurance Standards under the Proposed New Statutory Framework for Financial Reporting*.

The MED aims to produce a financial reporting system that is underpinned by a clear and coherent set of financial reporting principles and indicators, weighs the benefits of financial reporting against the costs of compliance, is consistent so similar entities are subject to similar requirements, and facilitates Australia/New Zealand harmonisation as far as possible to minimise the compliance costs for those entities which do business on both sides of the Tasman. The new framework is intended to be all encompassing and considers all entities in the for-profit, public and not-for-profit sectors.

## **The MED paper proposes:**

- New standard setting arrangements for accounting and auditing standards under a reconstituted ASRB, the External Reporting Board (XRB)
- A new more flexible process to determine which entities should have to report and at what level
- Preliminary views on the preparation, audit and filing requirements for each class of entity
- Consideration of some other related issues

## **The ASRB paper proposes:**

- The tiers of reporting and the qualifying criteria for each tier
- The nature of the likely accounting standards that would apply to each tier, and the assurance requirements that should apply to each tier
- The new structure of the XRB

## **The proposals will have some far reaching consequences including:**

- Small closely held companies, in particular small overseas owned and incorporated entities, may find that they no longer have any legislative financial reporting requirements.
- Large for-profit entities other than companies will be brought within the financial reporting regime.
- Many not-for-profit entities will become subject to financial reporting preparation, audit and filing requirements.
- Large, privately-held companies may be required to file audited financial statements. The MED is seeking feedback on applying the approach taken in Australia

**Denise Hodgkins**  
Partner, Deloitte



# Overview of the proposed statutory framework for financial reporting

## THE CORE PRINCIPLE

The MED has determined the core principle that should underpin the financial reporting system based on the notion of general purpose financial reports (GPFR). It has also determined that there are three supporting indicators that financial reporting is needed.

### The Primary Principle

The overarching reason for financial reporting is to provide information to external users who have a need for an entity's financial statements but are unable to demand them.

### Indicators that an entity meets the primary principle

Public Accountability

Separation of Ownership and Management

Economic Significance

The core principle recognises that some users such as banks and other funders are able to demand the information they need but that many users do not have this ability and are therefore forced to rely on GPFR for information about the entity. GPFR should therefore be focused on the needs of these users.

**Public accountability** exists when an entity receives money from the public. Entities which will likely be captured by this indicator include issuers, non-profit public sector entities and charities.

The **separation of ownership and management** indicator recognises that where the owners are not actively involved in the management or governing body of the entity that they are likely to be reliant on GPFR for financial information.

The last indicator recognises that large entities are likely to have a **significant economic or social impact** on the national or regional economy if they fail and therefore there is a broader stakeholder interest in the financial position and performance of these entities even if they have no public accountability or separation of ownership and management. At this stage the size criteria used to determine if an entity is economically significant is drawn from the "large" definition in s19A of the Financial Reporting Act 1993 (any two of the following: consolidated assets exceed \$10 million, consolidated annual revenue exceeds \$20 million, 50 or more full time equivalent employees).

This primary principle and the indicators are used by both the MED and the ASRB to determine the tiers of reporting, and the resulting proposed reporting, assurance and filing requirements for each class of entity.

which exempted companies that existed when the legislation came out (a "grandfathering" provision), but required new entities that met the economic significance criteria to file their audited financial statements.

Changes in the accounting standards are also proposed including:

- The International Accounting Standards Board's *IFRS for Small and Medium Entities* (IFRS for SMEs) may be adopted for non publicly accountable entities.
- The accounting standards of the International Public Sector Accounting Standards Board (IPSASB) may be adopted for public sector and not-for-profit entities instead of NZ IFRS.
- Simple Format Reporting for small not-for-profit and public sector entities.

We comment on the various proposals in the following articles and note that it will be important to ensure that the proposed regime harmonise with Australia as far as possible.

## Independent Standard Setting Body

The MED paper proposes to move the current standard setting activity to a reconstituted ASRB, renamed as the External Reporting Board (XRB). By removing standard setting from the NZ Institute of Chartered Accountants (NZICA), it ensures that standard setting is independent from interests of the accounting profession. It also reduces the two step process where standards were prepared by one body and approved by another. The XRB would have all responsibilities for developing and approving financial reporting, and auditing and assurance standards. This would make compliance with those standards mandatory for all audits performed under Acts, Regulations and other statutes. Currently auditing and assurance standards only apply to NZICA members. In particular, some not-for-profit entity audits not performed by an NZICA member would fall under the XRB's auditing and assurance standards.



# For-profit entities: publicly accountable and economically significant entities



**Jamie Schmidt**  
Partner, Deloitte

## Proposals

Broad entities Tier 1	Preparation	Audit	Filing	Accounting standards
Issuers of Securities traded in public markets (1)	✓	✓	✓	Pure IFRS
Fiduciary holders of assets –where it is a primary business of the entity (2)	✓	✓	✓ ?	Pure IFRS

- (1) Some issuers, such as retirement villages where the securities are not traded in a public market will fall into Tier 2, allowing use of IFRS for SMEs or Differential IFRS. Refer page 14.
- (2) Paragraph 1.3 of the IFRS for SMEs document published by the IASB states that “an entity has public accountability if it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.”

## Business as usual for issuers

For issuers it's largely business as usual however there may be some relief for issuers like retirement villages and unit trusts whose securities do not trade in a public market (refer below).

A new class of entity has been coined drawing from the IASB's definition of public accountability. Entities that hold assets in a fiduciary capacity as a primary business activity such as banks, finance companies and insurance companies will be required to comply with IFRS under the ASRB's proposals. Entities where the holding of assets in a fiduciary capacity is not their primary business activity, such as travel or real estate agents, or cooperative enterprises requiring a nominal membership deposit, would not be captured in this category. The MED paper is not clear on the filing requirements for these entities,

but as they are publicly accountable filing should be required. This might be mandated by other legislative requirements.

The ASRB proposes moving back to pure IFRS instead of using NZ IFRS. From a practical perspective this will reduce standard setting costs, but won't have a significant impact on entities affected. It will have some benefits such as:

- removing the add-on NZ specific disclosures,
- providing entities with the options existing in full IFRS such as the valuation of investment property at cost, and
- removing the requirement to have an independent valuer to perform or review the valuations of property, plant and equipment and investment properties.

Broad entities (1) Tier 2	Preparation	Audit	Filing	Accounting standards
Issuers of securities not traded in a public market	✓	✓	✓	IFRS for SMEs (if becomes generally accepted) or
Other large non-issuers including non-issuer overseas owned or incorporated companies	✓	✓	✓ x (4)	
SOEs, government owned companies, for-profit council owned entities and other for-profit public sector entities (2)	✓	✓	✓	Differential IFRS (if IFRS for SMEs not accepted)
Large non-issuer for-profit Maori governance entities (3)	✓	✓	✓	Can opt up to full IFRS.

- (1) A company is large, as defined in the section 19A of the Financial Reporting Act, if it exceeds any two of the following tests: (i) total assets of \$10million, (ii) annual revenue of \$20million, and (iii) 50 full time equivalent employees.
- (2) Under the MED document, all public sector entities regardless of size are required to prepare general purpose financial reports. All for-profit public sector entities therefore fall in this category, unless they are an issuer as discussed above.
- (3) Maori governance entities include a range of entities such as Trust Boards, Incorporations and Land Trusts which will be captured by the Framework where the economic significance criteria are met.
- (4) The MED document proposes requiring these entities to file their audited financial statements, with a “grandfathering” exemption, discussed below.

# For-profit entities: publicly accountable and economically significant entities

## Economic significance

As discussed in the Overview, economically significant entities have a broad stakeholder interest and therefore should be required to prepare financial statements. The thresholds for determining whether an entity is economically significant are outlined in the Financial Reporting Act and defined above. While most economically significant for-profit non-issuer entities are companies, this would require large partnerships and some Maori governance entities to prepare and have their financial statements audited. Large non-issuer companies will no longer be able to opt out of audit requirements.

The ASRB suggests a step down in reporting required for publicly accountable for-profit entities that are not issuers trading in a public market with the ability to adopt IFRS for SMEs or a differential IFRS framework to be developed jointly with Australia

## That filing question

The MED states that economically significant entities should be required to prepare, have audited, and publish general purpose financial statements. When the MED previously raised the possibility of getting such financial statements filed with the Companies Office there was a significant backlash. This time, the MED is seeking comment on the “grandfathering” approach Australia adopted in 1995 where large proprietary companies incorporated prior to the law change (that were large at the time or subsequently became large) did not have to comply with the new requirement to lodge their general purpose financial statements with the ASIC. The MED notes that approximately 70% of Australia’s large proprietary companies are now filing financial statements.

## Shorter filing periods for non-listed issuers

Entities listed on the stock exchange (NZSX/NZDX) are required to issue an annual report (including audited financial statements) within three months after the financial year end.

Non-listed issuers and other companies required to file financial statements have five months plus twenty days to file their financial statements. The MED paper seeks feedback on requiring non-listed issuers to file audited financial statements within four months of year end. This would bring reporting for non-listed issuers into line with the IOSCO’s *Objectives and Principles of Securities Regulation*. The MED also seeks comments on whether other companies with filing requirements should have the time limit for filing reduced.

## Step down from IFRS

The ASRB suggests a step down in reporting required for publicly accountable for-profit entities that are not issuers trading in a public market with the ability to adopt IFRS for SMEs or a differential IFRS framework to be developed jointly with Australia. This is a rather peculiar proposal for SOEs, government owned companies, for-profit council owned entities and other for-profit public sector entities. For those that are economically significant, given their public ownership, the ability to use a ‘cut-down’ reporting framework is not appropriate, and doesn’t align with the proposed framework for the Crown, local authorities and other significant public benefit entities where the IFRS equivalent public sector accounting standards (IPSAS) are proposed.

As many entities in this tier are already complying with NZ IFRS, the option remains to ‘opt up’ to the tier 1 reporting level where the accounting framework is pure IFRS.

## Parent only financial statements?

The MED has asked if the parent company preparation and filing requirements should be retained, modified or removed. The MED doesn’t have a current view, but notes that there were differences in view expressed when the IASB and FASB released their *Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Reporting Entity* in 2008. Some argued that parent company financial statements are useful because legal separation between a parent and subsidiaries can affect cash flows available to equity investors, lenders and other capital providers, and lenders and other creditors typically have a claim over the assets of the parent, not the subsidiaries.

# For-profit entities: publicly accountable and economically significant entities

Conversely, others argued that parent financial statements are potentially misleading because they present information about the parent's investment in its subsidiaries, not the underlying assets, liabilities and activities. Further, the parent financial statements don't provide reliable information about the parent's return on its investment in subsidiaries. As the parent financial statements only serve the information needs of a subset of capital providers they argue that parent only financial statements are special purpose – not general purpose.

The exemption in NZ IAS 27: *Consolidated and Separate Financial Statements* from preparation of consolidated financial statements by parent entities in a chain below an intermediate/ultimate parent which publishes consolidated financial statements will remain. This exemption also exists in the IFRS for SMEs.

## Remuneration disclosures under the Companies Act

At present a company annual report must state the number of employees with total remuneration of \$100,000 per year or more, shown in brackets of \$10,000. The MED believes that these figures are no longer a good proxy for identifying individuals in senior management positions, and seeks feedback on the following two tentative options (or suggestion of an alternative approach):

Option 1: Keep the current disclosure requirement but increase the total remuneration figure (e.g. \$150,000) and increase the band width (e.g. \$25,000).

Option 2: Change from the existing rules based approach to an outcomes based approach, as in Australia. The Australian Corporations Act 2001 requires disclosure of:

- Key management personnel only with full disclosure of their remuneration
- Discussion of the board's remuneration policy and relationship with company performance
- Performance conditions necessary for elements of remuneration, why chosen and way conditions are assessed
- Elements of remuneration that are performance related separately to those that are not
- Amount of employee entitlements paid in options.



# Small and medium sized for-profit entities



**Brendan Lyon**  
Partner, Deloitte

## Proposals

Broad entities (1) Tier 2	Preparation	Audit	Filing	Accounting standards
Non Large entity with 10+ Shareholders (not an issuer)	✓ with opt out (2)	✓ with opt out (2)	✗	IFRS for SMEs / Differential Reporting
Non Large entity with < 10 Shareholders (not an issuer)	✗ with opt in (3)	✗ with opt in (3)	✗	N/A

- (1) A company is large, as defined in the section 19A of the Financial Reporting Act, if it exceeds any two of the following tests: (i) total assets of \$10million, (ii) annual revenue of \$20million, and (iii) 50 full time equivalent employees.
- (2) Shareholders would be able to waive the requirement in certain circumstances, for example if no shareholder voted against such a motion at a general meeting.
- (3) Shareholders would be able to opt in to the preparation and audit requirements as for a non-large entity with 10+ shareholders shown above, for example if more than 5% of shareholders by value voted in favour.

The discussion documents propose some far reaching consequences for small and medium for-profit companies (SMEs), in particular small overseas owned companies and overseas incorporated entities doing business in New Zealand, who may no longer have any legislative financial reporting requirements.

As some SMEs have separation between management and owners they will still be required to prepare general purpose financial statements where the owners require them, in an opt-in/opt-out arrangement depending on the number of shareholders, with IFRS for SMEs or a differential reporting IFRS used (unless the entity chooses to opt-up and report using IFRS). The concept of differential reporting is reasonably widely understood in the Financial Reporting community in NZ and there is significant merit in the adoption of IFRS for SME, we outline some of the respective pros and cons of each on page 14. It will be important to harmonise with Australia in this regard.

If owners require general purpose financial statements, this change in accounting framework will affect entities currently preparing NZ GAAP financial statements. Some SMEs, especially overseas companies discussed below, will have only recently transitioned to NZ IFRS, so this proposal may be considered to be a further change in the financial reporting compliance regime. Looking forward there are significant further changes proposed to IFRS, with exposure drafts and discussion papers

already released proposing changes to accounting for tax, leases, revenue and more. By opting out of preparing general purpose financial statements, the 'pain' of future changes may be avoided.

## Non Large Overseas Companies

The proposal to remove the requirement for non-large overseas companies to file their financial statements removes the distinction between foreign owned and domestic companies giving relief to such entities. This will reduce the level of information available to local New Zealand suppliers who transact with these companies, where the publicly available financial statements may have provided valuable information on the credit worthiness and stability of such companies.

Non-large overseas owned or incorporated companies may choose to continue preparing general purpose financial statements to meet the requirements of group reporting (or local lenders), and can opt up to full IFRS if that is the basis that group reporting requires. If financial statements are prepared, they would not have to be filed.

## Special purpose financial statements

Small and medium companies whilst either not being required (<10 shareholders) or being able to opt out (>10 shareholders) of preparing general purpose financial statements may still have to prepare special purpose financial statements to meet the requirements of other users (i.e. financiers or regulatory authorities such as the IRD).



# Small and medium sized for-profit entities

Under the existing FRA, there is no specific financial reporting framework covering what special purpose financial statements are or what they should contain. This contrasts with the Australian Corporations Act 2001 which provides guidance as to what measurement and disclosures should be included in such special purpose financial statements.

To maintain the improved consistency and comparability of financial statements, which was envisaged with the introduction of IFRS, there is a requirement for increased guidance for users. The XRB or the New Zealand Institute of Chartered Accountants should issue guidance on the basis of preparation of special purpose financial statements.

From overseas investors/suppliers perspective any framework for special purpose financial statements should be consistent with a framework that is adopted internationally so that they can understand and gain confidence in the financial statements of New Zealand companies.

## Considerations for 'independent' directors of SMEs

Another consideration is how entities that opt out of preparing general purpose financial statements provide independent directors (e.g. in a family owned or husband/wife business who is joined on the board by an independent advisor) with sufficient information to discharge their fiduciary duties appropriately (e.g. solvency compliance when declaring a dividend and the continuing requirement to maintain proper accounting records).

Where there are other users, special purpose financial statements may be prepared providing some comfort to directors, and as discussed below, internal management accounts will still be required for solvency purposes. Directors will need to determine if this information is sufficient for their purposes.

## The Solvency Test

The Companies Act 1993 prohibits actions by directors (such as distributions to shareholders) where the entity would not be solvent immediately after carrying out the action. The test for solvency is currently done by reference to the entity's most recent general purpose financial statements and any other circumstances that the directors know or ought to know about the value of the company's assets and liabilities (including contingent liabilities). As the proposals will reduce the number of entities preparing general purpose financial statements, there is a proposal to change the wording of the solvency test requirements. The preferred view in the paper is to include reference to the accounting records required under section 194(1) of the Companies Act 1993. This section will continue to require the board of a company to cause accounting records to be kept that (a) correctly record and explain the transactions of the company, and (b) will at any time enable the financial position of the company to be determined with reasonable accuracy.

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There are far reaching consequences for SMEs, in particular small overseas owned companies and overseas incorporated entities doing business in New Zealand who may no longer have legislative financial reporting requirements

# Public sector entities



**Jacqueline Robertson**  
Partner, Deloitte

## Proposals

Broad entities (1)	Preparation	Audit	Filing	Accounting standards
<b>Tier 1:</b>				
Crown, Local Authorities and other public sector entities with expenditure ≥ \$20m (2)	✓	✓	✓	NZ PBE Accounting Standards (IPSAS)
<b>Tier 2:</b>				
Other public sector entities with expenditure ≥ \$2m and < \$20m, and public benefit entities which are issuers with expenditure below \$2m	✓	✓	✓	Differential PBE Accounting Standards (Differential IPSAS)
<b>Tier 3:</b>				
Other public sector entities with expenditure < \$2m	✓	✓ (3)	✓	Simple Format Reporting

- (1) State owned enterprises, government owned companies and council controlled trading organisations (for profit) will report in accordance with IFRS (if issuer or securities in a public market or holder of assets in fiduciary capacity), or IFRS for SMEs as per page 4. Entities in tier 2 or 3 can opt up to a higher tier if they so choose.
- (2) This category will include ACC, EQC and the Fire Services Commission, and any other entities that are leviers of coercive revenue should they exist.
- (3) Limited assurance engagement only. A review engagement provides limited assurance, in the form of a negative expression of the practitioner's conclusion ("nothing has come to my attention"). This compares with an audit opinion which provides reasonable assurance in the form of a positive expression of the practitioner's conclusion.

## Requirements to prepare General Purpose Financial Reports

The MED continues to propose that public sector entities be required to prepare financial statements on the basis of public accountability.

## Proposed Accounting Standards Frameworks

### For profit public sector entities

Public sector entities that are "for profit" and are publicly accountable (ie issuers), would be required to adopt IFRS in full. Interestingly, the Tier structure proposed by the ASRB in relation to the accounting standards to be adopted does not include size criteria. Therefore State Owned Enterprises that are not issuers would be allowed to adopt some form of differential reporting, irrespective of their economic size.

### Public benefit entities within the public sector

There are considerable changes proposed in relation to the financial reporting requirements required to be adopted by public benefit entities within the public sector.

The ASRB proposal is that public benefit entities within the public sector, be required to adopt the standards issued by the International Public Sector Accounting Standards Board (IPSASB). Depending on size, public benefit entities that do not have coercive powers to levy, would adopt the full suite of IPSAS, with a differential reporting option to be developed in New Zealand.

The standards issued by the IPSASB are based largely on IFRS with changes made where appropriate to allow for the specialist nature of public benefit entities within the public sector. For example, standards have been issued on:

- reporting historical results against budgeted information;
- accounting for impairment of assets that are not designed to generate a commercial return; and
- accounting for revenue that is not derived through a normal commercial transaction.

# Public sector entities

Preparers and users of these standards need to be aware that many of the contentious (in the view of the public sector) and complex areas of IFRS (such as IAS 39 and accounting for low interest loans) will not be removed by the adoption of IPSAS.

The ASRB paper recognises that there are some risks with adopting the IPSASB approach. One of the key issues is that the IPSASB does not have the same level of independence as the IASB and its governance and resourcing arrangements may pose a risk to the ongoing development of quality public sector standards.

## Simple format option

A simple format option is also proposed under a new tier three for public sector entities with expenditure less than \$2m (assuming they do not have the power to levy or are issuers). These entities would only be required to prepare a “simple format” report. It is also proposed that these entities would only be required to have a “review” rather than an audit.

This option has the potential to impact a considerable number of public sector entities and is likely to capture a large number of schools. Whilst individually these entities are small, collectively the amount of expenditure could be considered to be significant and some thought needs to be put into whether a review assurance option is sufficient if collectively there are significant public funds being expended.

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Preparers and users of these standards need to be aware that many of the contentious (in the view of the public sector) and complex areas of IFRS (such as IAS 39 and accounting for low interest loans) will not be removed by the adoption of IPSAS



# Not-for-profit entities



**Lisa Cruickshank**  
Partner, Deloitte

## Proposals

Broad entities Entities can choose to opt up to a higher tier	Preparation	Audit	Filing	Accounting standards
<b>Tier 1:</b> Publicly accountable (1) and other not-for profit entities where expenditure ≥ \$10m (2)	✓	✓	✓	Full PBE Accounting Standards (IPSAS) – NFP application
<b>Tier 2:</b> Publicly accountable not-for profit entities with expenditure ≥ \$1m and < \$10m	✓	✓	✓	Differential PBE Accounting Standards (Differential IPSAS) – NFP application
Other not-for-profit entities with 10+ members and expenditure ≥ \$1m and < \$10m (4)	✓	✓	✗	
<b>Tier 3:</b> Publicly accountable not-for profit entities with expenditure ≥ \$20k and < \$1m (5)	✓	Depends. Entities with expenditure > \$100,000 would be subject to a review engagement (3), otherwise no requirement.	✓	Simple Format Reporting
Other not-for-profit entities with 10+ members and expenditures ≥ \$20k and < \$1m (4)	✓		✗	
Entities with operating expenditure < \$20k, unincorporated entities (that have not registered with the Charities Commission), and gaming machine societies (6)	✗	✗	✗	No requirement to prepare general purpose financial statements

- (1) Publicly accountable not-for-profit organisations comprise registered charities and any other not-for-profit organisations that receive funds from the public (such as incorporated societies, industrial and provident societies) or tax or rates rebates.
- (2) Donor entities (e.g. major private philanthropists making significant donations in a year) would only be required to file financial statements if the entity's non-donation operating expenditure met this criteria.
- (3) A review engagement provides limited assurance, in the form of a negative expression of the practitioner's conclusion ("nothing has come to my attention"). This compares with an audit opinion which provides reasonable assurance in the form of a position expression of the practitioner's conclusion.
- (4) Entities can choose to opt-down or opt-out in certain circumstances.
- (5) If the public benefit entity with expenditure ≥ \$20k and < \$1m is an issuer, then it will have to report in accordance with tier 2.
- (6) The MED states that gaming machine societies are excluded from mandatory financial reporting obligations, however section 108 of the Gambling Act 2003 requires preparation of annual reports including financial statements required by the FRA or NZ GAAP. This inconsistency needs to be addressed in any legislation arising from the discussion document.

## The Not-for-profit Sector is being called to account

With the increasing profile and proliferation of charities and other not-for-profit entities there has been a growing call from the public for greater transparency and accountability by this sector. Donors and members are looking for better information to judge the financial and non-financial performance of these organisations and to make decisions about where to invest their scarce dollars for the greatest benefit.

Whilst the introduction of the Charities Commission has brought some accountability (registered charities are required to provide certain financial information and financial statements are required to be filed with the Commission if they have been prepared), the status quo position doesn't mandate the preparation of financial statements under a common set of standards so results in a lack of comparability across the sector with financial information being prepared using different and sometimes unclear recognition and measurement policies.



# Not-for-profit entities

The proposed statutory framework for Financial Reporting aims to address this demand by requiring non-profit entities to prepare, file and have assured (ie audited or reviewed) general purpose financial reports prepared in accordance with prescribed accounting standards where the benefits of doing so outweigh the costs.

In considering whether the benefits outweigh the costs the MED has proposed a tiered approach as illustrated in the diagram above. Entities will be able to opt up to a higher reporting tier if owners, members or funders require. Members or owners of entities which are not publicly accountable will also be able to opt down or out of preparation and assurance requirements although the process and criteria for doing so (e.g. whether unanimous resolution is required) is outside the scope of the papers.

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## Under the proposed new framework all registered charities and other not-for-profit entities that receive funds from the public will be considered publicly accountable

### Public accountability definition expanded ...

Many non-profit entities currently take advantage of differential reporting exemptions available under superseded NZ GAAP and NZ IFRS on the basis that they are “small” and do not have public accountability, as soliciting or receiving funds from the public, providing services to the public, or producing reports for issue to the public, do not constitute public accountability under the current Framework.

Under the proposed new framework all registered charities and other not-for-profit entities that receive funds from the public will be considered publicly accountable. The impact of this wider definition on scope of reporting however appears to be offset by the use of economic substance as the driver to determine whether an entity can apply differential PBE accounting standards.

### Expenditure to drive the tier threshold

Unlike their for-profit counterparts and the existing differential reporting framework the non-profit entities’ thresholds for financial reporting tiers are based on a single driver of operating expenditure. The argument for this being revenue and assets are not good indicators of economic significance because they can be distorted by fluctuations in donation revenue and by heritage or endowment assets that are not indicative of operating activity. This requires further thought however as it could be argued that an entity which raises millions of dollars in donations from the public or is entrusted with safeguarding and properly maintaining a vast endowment fund or asset is an entity of economic substance. Individuals making a significant donation to an entity in response to a public appeal may be interested to know if the funds had not been spent on its charitable purpose or at all, or if the entity already had sufficient reserves to fund its activities for the next 20 years.

Operating expenditure is not defined in the discussion paper and early clarification of this will be important. How broadly operating expenditure is defined will have a significant impact on which tier some entities fall into. For example, if donations to other not-for-profit entities and fair value movements are excluded from the definition this will reduce the number of entities falling into the tier 1 and 2 categories.

### Out with IFRS and in with IPSAS

Where not-for-profit entities are required under the framework to prepare general purpose financial reports it is proposed that these will need to comply with a set of public benefit entity accounting standards to be established. For tier 1 and 2 entities these standards will be based on International Public Sector Accounting Standards modified for application to the not-for-profit sector with differential reporting exemptions available for tier 2 entities. For tier 3 entities a relatively simple set of reporting requirements referred to as ‘simple format reporting’ will apply which will require accrual accounting, fundamental sector-based disclosures and measurement bases aligned with the full PBE standards.

This move away from IFRS recognises the fact that IFRS has been developed largely with profit-oriented entities in mind and does not cater to the specific needs and users of the sector. Whilst the overall approach appears

# Not-for-profit entities

sensible for the vast majority of entities in this sector which will report under simple format reporting the discussion paper provides little detail and transition timeframes of 2-3 years mentioned in the discussion paper mean that clarification of exactly what this entails may be some time off so the achievement of improved comparability and transparency in the sector is not going to be rapidly resolved.

For large entities who have invested heavily in transitioning to NZ IFRS there will be concern that the transition to the new PBE standards will create yet another compliance burden for an industry that does not typically have large financial reporting resources. Whilst the ASRB paper asserts that convergence projects may mean that there are few differences this remains to be seen and many organisations may need to come to grips with Statements of Service Performance for the first time.

For groups of entities which have a mix of for-profit and not-for-profit entities the departure from IFRS may require some group entities to maintain additional or duplicate accounting records to enable each entity and the group to report under their mandated different accounting standards.

## **New filing requirements bring greater accountability and accessibility**

Tier 1 and 2 entities not currently required to file financial statements with the Charities Commission or other public offices will be required to file financial statements with the Companies Office.

The proposed assurance requirements for tier 1 and 2 reporting entities to be audited and the financial statements of tier 3 reporting entities with operating expenses over \$100,000 to be subject to a review engagement appear to be reasonably in line with public expectation but further consideration could be given to:

- whether the public really understands the limitations of a review engagement and the lower level of assurance it provides relative to an audit

- whether the limitation in scope qualification that commonly arises in the audit reports of small and medium not-for-profit organisations (which typically have insufficient resources to implement practical controls over revenue prior to initial recording) could be better handled by amending the scope of the assurance report so that unqualified reports are a feasible objective at each tier in the sector.

## **The change path**

The future looks promising for increased comparability and transparency but the path looks to be long and rocky with significant effort required to establish and implement the new PBE reporting framework and to get buy in and conformance from the sector without undue cost.



# IFRS for SMEs vs differential reporting IFRS

**The International Accounting Standards Board has recently issued a new standard entitled IFRS for SMEs. This was in response to requests from a number of countries to produce a set of financial reporting requirements for smaller entities. The IASB does not mandate its use. It is up to each jurisdiction to decide whether or not to use the standard.**

Since New Zealand adopted IFRS there has been a differential reporting framework in place where entities which qualify for differential reporting have been granted a number of recognition, measurement and disclosure exemptions from the IFRS requirements. This was a temporary measure pending the outcome of the IASB's project. Now that the IASB has completed the IFRS for SMEs, it is time to decide whether or not New Zealand should adopt the standard or continue with its differential reporting framework.

## **Reasons to adopt the standard include:**

- the standard is an international standard which users from other jurisdictions will be familiar with, which entities looking to step up to IFRS in the future may benefit from
- the standard is less voluminous than the suite of IFRS which exceeds over 2000 pages so preparers and users will be able to get to grips with the requirements perhaps more easily
- the standard will only be updated bi-annually which means that there will be fewer changes to cope with than those likely to result under IFRS which undergoes many changes in an annual period
- the standard setting costs to New Zealand will be reduced since amendments to IFRS are not required.

## **Reasons to retain differential reporting IFRS include:**

- Using the differential reporting framework means that preparers and users only need to be familiar with one set of standards instead of two. This improves the portability of accounting skills and knowledge.
- There is less guidance on the application of the requirements of the standard (which is partly why IFRS is so voluminous). Looking to full IFRS may not provide the answers where the requirements are not exactly the same.

- There will be a lag in potential changes arising from changes to IFRS.
- The standard is not substantially less onerous than IFRS. It has many similar requirements but without the guidance.

A joint statement of intent addressing a Single Economic Market was issued by the Australian and New Zealand Prime Ministers in August 2009. The statement aims to enable Trans-Tasman companies to prepare only one set of financial statements in compliance with one set of standards. The statement goes further to aim for a single set of accounting standards that for-profit entities and not-for-profit entities can use. As a result, any decision on the whether IFRS for SMEs or a differential reporting framework is adopted (in isolation or in parallel with IFRS for SMEs), will need to be made in consultation with Australia. The MED therefore only seeks feedback on material concerns with IFRS for SMEs, what factors should be considered when choosing between the IFRS for SMEs and differential reporting, and any benefits that might result from joint development of a differential framework with Australia.



# Too many standards?

The proposed framework set out by the ASRB, is a sector based approach, leading to five different sets of accounting standards:

- Full IFRS,
- IFRS for SMEs or Differential Reporting IFRS,
- Public Benefit Entity – IPSAS, including a not-for-profit application
- Public Benefit Entity – Differential IPSAS, including a not-for-profit application
- Simple format reporting.

While New Zealand has long embraced sector neutral standards, there has been increasing concern with the use of IFRS as a basis for NZ IFRS, given that IFRS is prepared solely for large profit oriented entities. In particular, the public sector has long been arguing for standards more tailored to their circumstances.

A sector based approach should result in information better tailored to the needs of users. It should also enhance comparability for public benefit entities and not-for-profits, particularly as some entities have chosen to provide additional information or alternative presentations more relevant to their business, which other entities have not given.

On the flip side, keeping up to date with five different reporting methods plus not-for-profit applications, will be time consuming for practitioners who have clients across several sectors. Multiple standards also reduce the portability of accounting skills and knowledge for accountants moving between sectors.

Standard setting may or may not be more costly as the increased number of frameworks and standards may be offset if the 'pure' form of the standards is adopted. This will depend in part on the ASRB's review of whether the IPSASB standards will meet the standard and quality necessary to be used and how extensive the not-for-profit application changes are.

The use of sector specific standards will be of particular interest to mixed groups (for example a public sector entity with a for-profit subsidiary that is required to prepare financial statements). The ASRB paper states that this issue is not that significant because the IPSASB has a programme of convergence with IFRS, and as the not-for-profit application is derived from IPSAS there should be "substantive similarity". While this may be true at present, it is uncertain whether such similarity will continue, particularly as the IASB has to date been more active than the IPSASB in issuing standards, interpretations and amendments. In addition, it remains to be seen whether the IPSASB's goals of

- continuing work on a conceptual framework for public sector reporting, and
- convergence with IFRS

are mutually compatible.





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