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Accounting Standards Review Board

PROPOSED APPLICATION OF ACCOUNTING AND ASSURANCE
STANDARDS UNDER THE PROPOSED NEW STATUTORY FRAMEWORK
FOR FINANCIAL REPORTING

Discussion Document

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Table of Contents

| | Page |
|---|-----------|
| Executive Summary | 5 |
| Information and Questions for Submitters..... | 9 |
| List of Abbreviations | 12 |
| 1. Introduction | 14 |
| 1.1 Purpose of this Document | 14 |
| 1.2 Overview of the MED and ASRB Discussion Documents..... | 14 |
| 2. General Framework for the Application of Accounting and Assurance Standards | 17 |
| 2.1 Introduction..... | 17 |
| 2.2 Relevance of the MED Financial Reporting Framework | 17 |
| 2.3 Operationalising User Needs and Cost-Benefit through Sectors and Tiers | 19 |
| 3. Proposed Accounting Standards Framework: For-Profit Entities..... | 25 |
| 3.1 Introduction..... | 25 |
| 3.2 Key Factors in the For-Profit Sector | 25 |
| 3.3 For-Profit Reporting Tiers..... | 26 |
| 3.4 For-Profit Accounting Standards..... | 28 |
| 3.5 Summary of For-Profit Proposals..... | 30 |
| 4. Proposed Accounting Standards Framework: Public Benefit Entities | 32 |
| 4.1 Introduction..... | 32 |
| 4.2 Key Factors in the PBE Sector..... | 32 |
| 4.3 PBE Sector Reporting Tiers..... | 33 |
| 4.4 PBE Sector Accounting Standards | 37 |
| 4.5 Summary of PBE Sector Proposals..... | 42 |
| 5. The Proposed Assurance Framework | 44 |
| 5.1 Introduction..... | 44 |
| 5.2 Cost-Benefit Approach..... | 44 |
| 5.3 Assurance Tiers and Levels | 45 |
| 5.4 Assurance Standards..... | 46 |
| 6. Related Issues and Comments..... | 48 |
| 6.1 Introduction..... | 48 |
| 6.2 General Framework Issues | 48 |
| 6.3 Assessment against the Section 2 General Framework | 50 |
| 6.4 Development and Implementation Issues..... | 53 |

| | |
|--|-----------|
| Appendix 1: Proposed Organisational Arrangements for the External Reporting Board..... | 55 |
| Appendix 2: Responses to Invitation to Comment on Proposed Revised Release 8 | 57 |
| Appendix 3: Current and Proposed Accounting Standards for Entities with GPFR Obligations..... | 59 |
| Appendix 4: Approach of Other Jurisdictions | 62 |

Executive Summary

Purpose of this Document

This ASRB Discussion Document is a companion to the Ministry of Economic Development's (MED) discussion document on "The Statutory Framework for Financial Reporting" (the MED Document). The MED Document considers the circumstances under which the law should impose requirements on entities to prepare, publish and obtain assurance on General Purpose Financial Reports (GPFR). The main focus of this document is on the accounting standards that should be used when preparing GPFR (by entities required to do so under the MED framework), and the level of assurance that should be provided on those reports.

The ASRB regards it as important that stakeholders are able to consider both the MED Document and the possible accounting standard and assurance arrangements that might accompany it all at the same time. Responses to this document and the ASRB's consideration of those responses will guide the future development and application of accounting standards in New Zealand.

The document considers four main issues:

- Some broad proposals for how the new body proposed in the MED Document to have future responsibility for accounting and assurance standards (a reconstituted ASRB called the External Reporting Board) might organise itself;
- Whether there should be tiers of reporting, and if so the qualifying criteria for each tier;
- The general nature of the accounting standards that should apply to each tier; and
- The assurance requirements that should apply to each tier.

External Reporting Board

Under the MED proposal the External Reporting Board (XRB) would be responsible for financial reporting strategy; the preparation and approval of accounting standards; and the preparation and approval of auditing and assurance standards. The Board's view is that these functions require different skill sets and focus and the XRB should be structured accordingly. Its tentative proposal is that this should include the establishment of two standard setting boards which would be responsible for the development, approval and promulgation of accounting and assurance standards respectively.

Framework for Tiers and Standards

The MED's Primary Principle (information to meet user needs) and associated indicators (public accountability, economic significance and separation of ownership and management), provides the framework to address reporting tiers, and accounting and assurance standards requirements. While users and their information needs can be categorised in numerous different ways, the Board's view is that the distinction currently used between for-profit and public benefit entity (PBE) sectors is a useful and cost effective basis for doing so. It is often also useful to recognise the difference between public and not-for-profit entities within the PBE sector, as the users and their needs are not always the same. In this context, and in light of the strong for-profit focus of the International Financial Reporting Standards (IFRS), the Board's tentative proposal is that New Zealand should move to a sector-specific set of financial reporting requirements to better reflect the difference in users and their needs.

The Board's tentative proposal is that, in line with current practice, tiers should be used to recognise the variability in the cost-benefit of information provided to users. In relation to

the number and criteria for tiers, the Board's tentative proposal is that they should be established on a sector-specific basis to allow for different user needs, differing cost-benefit considerations and other sector-specific constraints to be taken into account. The Board also proposes that entities should be able to 'opt-up' from one tier to another i.e. apply the requirements of a higher tier if they so choose.

For-Profit Sector Reporting

In relation to for-profit entities, the MED Document only requires publicly accountable entities (defined as issuers and holders of assets in a fiduciary capacity), large entities (tentatively defined as two of: $\geq \$20\text{m}$ revenue, $\geq \$10\text{m}$ assets, ≥ 50 staff), and entities with a management/shareholder separation (tentatively defined as 10 or more shareholders unless the shareholders decide to opt-out of the reporting requirement) to prepare GPFR. This means that non-large companies (and other for-profit entities) will no longer be required to prepare GPFR and as a result the reporting framework does not need to address small for-profit entities. Accordingly, the Board's tentative proposal is to have a two-tier reporting framework for this sector.

The recently released International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) creates a distinction between publicly accountable entities (defined as issuers of securities traded in a public market or entities that hold assets in a fiduciary capacity as a primary business activity) and non-publicly accountable entities. The Board's tentative proposal is that the for-profit Tier 1 should comprise entities that meet the IASB public accountability definition. All other for-profit entities required to prepare GPFR would fall into Tier 2. This would include issuers of securities that are *not* traded in a public market, large non-issuer companies (including applicable State Owned Enterprises), and large non-company for-profit entities.

In relation to accounting standards, the Board's tentative proposal is that Tier 1 should be required to comply with (pure) IFRS rather than New Zealand equivalents. There are very few substantive differences between NZ IFRS and IFRS and the benefits of preparing New Zealand equivalents therefore probably don't justify the costs.

As far as Tier 2 is concerned, the Board has identified two alternative reporting options that could be applied: IFRS for SMEs; or New Zealand specific differential IFRS (broadly along the lines of the current Differential Reporting Framework). In considering these options the Board notes that IFRS for SMEs has been specifically developed as a version of IFRS for entities that are not publicly accountable (under the IASB definition). The adoption of IFRS for SMEs would allow these entities to assert compliance with appropriate internationally set standards, enhancing the credibility of their reporting. Further, there are significant cost-benefit advantages (from a standard setting perspective) in using international standards.

On the other hand the Board recognises that, as it has only recently been released, there is some uncertainty amongst constituents about the usefulness and relevance of IFRS for SMEs as a *differential* version of IFRS for application in New Zealand. In particular, the differing measurement and extensive disclosure requirements of IFRS for SMEs, means that its suitability for use as a differential version of IFRS (in contrast to being a parallel full version for non-publicly accountable entities) is still being assessed both in New Zealand and Australia. The alternative would be to use a domestically developed Differential IFRS framework, preferably developed jointly with Australia for application in both countries.

The Board is conscious of the complexity and importance of the Tier 2 reporting decision and is therefore keen to receive comments from respondents on the factors (and their relative weighting) that the Board should take into account when choosing between these two options for reporting by Tier 2 for-profit entities (IFRS for SMEs; or a New Zealand-Australia developed Differential IFRS option).

PBE Sector Reporting

The public accountability requirements of the MED Document mean that many small PBE entities will be required to prepare GPFR. This is because all public sector PBEs are publicly accountable, regardless of size, as are all registered charities (although under the MED Document not-for-profit entities with operating expenditure under \$20,000 would not be required to report). In light of this the Board's tentative proposal is that there should be three tiers for the PBE sector to cater for large, medium and small entities.

In terms of tier thresholds, the Board's tentative proposal is to use expenditure (rather than revenue, assets or employees) as the base in the PBE sector. This is because it is more reflective of underlying activity in most PBE entities than revenue (that can fluctuate with donation levels, for example). In terms of levels, the Board's tentative proposal is for Tier 1 to be expenditure \geq \$20 million (public sector) or \geq \$10 million (not-for-profit sector); Tier 2 expenditure between \$20 million-\$2 million (public sector) or \$10 million-\$1 million (not-for-profit sector); and Tier 3 expenditure under \$2 million (public sector) or under \$1million (not-for-profit sector). The different tier thresholds are designed to create a rough equivalency between the two PBE sectors based on a broad assumption about the lower level of personnel costs in not-for-profit sector entities (as they generally rely on volunteers).

In addition, the Board's tentative proposal is that all public sector entities that levy coercive revenue should be included in Tier 1. This is to reflect the higher public accountability obligations of these entities. PBEs that are issuers should fall into whatever tier is appropriate under the size and coercive revenue criteria provided that they should never fall below Tier 2. This is to ensure that the quality of reporting is adequate to meet their user's needs.

In terms of accounting standards for the PBE sector, the Board's tentative proposal is that a set of NZ PBE Accounting Standards be developed for use in the sector. Those standards would consist of (pure) IPSAS for public sector entities, together with a NFP Application for use in the not-for-profit sector, (Tier 1); and differential versions thereof for both public sector and NFP entities (Tier 2).

In relation to PBE Tier 3 entities, the Board's tentative proposal is that Simple Format Reporting be required. In broad terms this would require the use of accrual accounting, measurement bases aligned with the full PBE standards where applicable, and fundamental disclosures appropriate to the sector. Minimum requirements would include: a Statement of Financial Position and Statement of Financial Performance; and simple service performance reporting. A template type approach is envisaged.

Assurance Requirements

The Board's tentative proposal is that the same tier structure also be used to determine statutory assurance obligations. In order to match costs and benefits Tiers 1 and 2 would be required to obtain an audit engagement but Tier 3 would be able to have a review engagement. Under the MED Document not-for-profit entities with expenditure under \$100,000 would not be required to obtain assurance.

The XRB (via an operating Board of the XRB established for the purpose) will also be responsible for issuing standards to be applied by assurance providers in conducting audits and reviews. As there is little substantive difference between international assurance standards and New Zealand equivalents an option would be to use the pure standards where possible. This would include the International Standards on Auditing (ISAs), the International Standards on Review Engagements (ISREs) and relevant ethical pronouncements. These Standards would apply to all assurance providers, not just those

that are members of New Zealand Institute of Chartered Accountants as is the case currently.

Implementation and Transition Issues

The implications of applying (pure) international standards will need to be worked through carefully and appropriate safeguards put in place. In this context the Board's tentative proposal is that the XRB have a 'safeguard authority' to allow it to not approve the application of an international accounting or assurance standard that is inappropriate in a material respect in the New Zealand environment; and provision be made for the issuing of (a limited number of) additional New Zealand-specific accounting or assurance standards to deal with areas not covered by international standards but important in the New Zealand context (such as Summarised Financial Reports, or Prospective Financial Information).

This document outlines in only broad terms the accounting and assurance standards framework the Board considers might operate within the MED framework. Further development and consultation will be required if these proposals are to be progressed.

The adoption of a new accounting and assurance standards framework will require a transition process not dissimilar to that required for the adoption of NZ IFRS in the 2005 - 2007 period, although not as extensive in scope. This can be addressed over a period of two to three years as it is likely that it will take that long for any new framework to be put in place. However, there may be some aspects of the accounting standard proposals that can be progressed in the interim and these would be subject to consultation.