

Submission

by

Business|NZ

to the

Ministry of Economic Development

on the

**Review of the Financial Reporting Act 1993
Part I: The Financial Reporting Structure**

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1. INTRODUCTION

- 1.1. Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 56-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.
- 1.2. In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.
- 1.3. Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services).
- 1.4. It is widely acknowledged that consistent, sustainable economic growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.
- 1.5. Business success and growth is fundamental in achieving the aims of higher economic growth for the country. A key area where business success can be accurately measured are the financial documents that are regularly compiled. Financial reporting provides all users of the data with key information about the past, present and future directions of the business. However, these responsibilities should never be set beyond what is reasonably required, both by internal and external users. Uniformity in the way financial data is presented has strong support in the business sector but there are concerns over the proposed filing requirements and the possibility that financial data may have to be released publicly. This is especially a concern for closely held companies.
- 1.6. Business New Zealand welcomes the opportunity to provide comment on part 1 of the Financial Reporting Act (FRA) discussion document that the Ministry of Economic Development (MED) has released. We also look forward to providing feedback on part 2 of the FRA review covering other issues when that discussion document is released later this year. While the discussion document regarding part 1 of the FRA review has asked a series of questions in each of the four topics, Business NZ instead wishes to make more general comments.

2. Summary of Recommendations

2.1. Business New Zealand recommends that:

- (a) Assets as a proposed criterion for evaluating whether a company is deemed to be large is removed and the associated number of FTE employees as a proposed criterion is increased from more than 20 to more than 50 FTE employees.
- (b) Notwithstanding the previous recommendation that assets should be removed as one of the criteria for classifying which tier an entity would fall into, if the Government intends to continue using assets as a criterion, that the minimum level be \$5 million a year. Also, that the threshold for turnover be at the minimum level of \$10 million a year.
- (c) An optional “best practice” regime for small entities should not proceed.
- (d) The option of filing and auditing be based solely on decisions reached by the owners/shareholders and stakeholders of the entity.
- (e) Notwithstanding the fact that Business New Zealand would like to see auditing and filing requirements be left solely in the hands of owners/shareholders and stakeholders to decide, we would be in favour of allowing a shifting tier (both up and down) on the basis of an owner or shareholder vote for auditing and filing requirements.
- (f) Further clarification is required of the conditions to establish whether an entity has “reporting requirements” to ensure that closely held companies are not included in the definition
- (g) A uniform financial reporting regime that encompasses all forms of entity (i.e. entity neutrality) should *not* be introduced.
- (h) The ASRB proposal of adapting IFRS for public sector entities in New Zealand is implemented.

3. Application of International Accounting Standards in New Zealand

- 3.1. Business New Zealand agrees that the adoption of International Financial Reporting Standards (IFRS) is an important step forward for both New Zealand’s financial reporting landscape and how New Zealand’s reporting standards are viewed overseas. While there are strong benefits from the adoption of IFRS, it is important that the transition does not forgo all unique standards that apply well within New Zealand for the sake of complete financial reporting parity with other countries. The country case studies outlined in the discussion document show the breadth of requirements that can exist and be unique for each country. Therefore, consideration of New Zealand’s specific requirements should not be completely abandoned for the sake of international conformity.

4. Financial Reporting Structure

- 4.1. Business NZ is strongly supportive of having different reporting requirements for different types and sizes of entities in New Zealand. We agree with MEDs comment regarding the level of financial reporting compliance burden based on the size of the entity - *“it is less apparent that the compliance burden is justified for medium-sized enterprises, and even less so for small operations”*.
- 4.2. The standard size of New Zealand businesses is somewhat unique compared with other countries we generally compare ourselves with. New Zealand is typically a country of small businesses owners, with few large enterprises, especially in the private sector.
- 4.3. To put these figures into perspective with overseas definitions, New Zealand typically regards micro sized businesses as those with 0-5 FTEs, while small-medium entities are those with 6-19 FTEs. Those above 99 FTEs are generally classed as large entities. In comparison, the European Union defines small businesses as having up to 49 employees, while medium sized businesses have 50-249 FTEs. The OECD classifies those with up to 99 employees as small, and 100-499 as medium.¹ Therefore, any domestic changes regarding financial reporting to mirror overseas standards can have a highly disproportional effect on very small New Zealand businesses that may not be able to cope with the associated compliance costs.
- 4.4. Business New Zealand generally agrees with the proposal that has been put forward in the discussion document that creates three tiers of entities for financial reporting requirements. However, any fundamental shift in the regulatory thresholds for financial reporting will invariably create ‘winners’ and ‘losers’ - those who find that their reporting compliance requirements have fallen, while others have found it to increase. Given the proposed reporting framework in the discussion document, those ending up with increased reporting duties may be small businesses as well as various charities and sports clubs that often rely on voluntary staff or a few chosen officers accountable to its members.
- 4.5. The FRA discussion document frequently refers to feedback received on the MED discussion document *Financial Reporting for Small Companies (FRSC)*, which was released in October 2002. Business New Zealand took the opportunity to comment on the document, making key recommendations including:
- The removal of the Exempt Companies Regime;
 - The establishment of one set of financial records that serves all regulatory purposes;
 - A change in using assets as a criterion for exemption;
 - A change in the threshold levels; and
 - Obligations to prepare statutory financial statements based on the will of the owners/shareholders and stakeholders.

¹ UNEP, *Industry and Environment*, Volume 26, No. 4, October-December 2003

We note that some of these recommendations relate directly to the financial reporting framework that has been proposed in the FRA discussion document.

- 4.6. The FRA discussion document has proposed assets, turnover and the number of FTE employees as the three thresholds for determining which tier an entity would belong in. Our FRSC submission viewed turnover as a more accurate measure in terms of a threshold, because asset testing can be subject to manipulation by companies. Assets can be placed in a trust and leased back to the company, meaning a company can control asset value. However, a turnover value cannot be so easily manipulated.
- 4.7. The FRA discussion document has also proposed that the third threshold – the number of FTE employees - be set at more than 20 FTE employees. Given that the vast majority (96.8%) of New Zealand businesses employed less than 20 FTE employees, Business New Zealand is supportive of a threshold mark for FTE employers, although we believe there would be scope for an increase to say more than 50 FTE employees, which would encompass many entities still expanding their business to the point of developing new product lines and looking at possible export opportunities. Once an entity is large enough, trained in-house workers are more likely to be employed to handle financial reporting responsibilities. Therefore, it is important that as many compliance costs and barriers are reduced as much as possible so that the transition from a small-medium size business to a large one is more easily made.
- 4.8. The asset and turnover thresholds proposed are similar to Australia but a much lower threshold has been chosen for employee numbers. Raising the threshold to 50 FTE employees would more closely align the New Zealand financial reporting provisions to the Australian definition for a large proprietary company. As noted earlier this is still much lower than European or OECD thresholds.

Recommendation: Assets as a proposed criterion for evaluating whether a company is deemed to be large is removed and the associated number of FTE employees as a proposed criterion is increased from more than 20 to more than 50 FTE employees.

- 4.9. Notwithstanding the fact that Business New Zealand would like to see assets removed as one of the criteria for classifying which tier an entity would fall into, our FRSC submission stated that threshold levels for turnover and assets be raised to the same monetary level of the Australian criteria for a small company. Therefore, we recommended at the time that the turnover threshold be raised to \$10 million a year, and that the threshold for assets be raised to \$5 million a year. It is pleasing to see that the FRA discussion document has proposed those same threshold levels. However, the discussion document states that any strict numerical thresholds would be able to be changed easily. Business New Zealand would not be in favour of any subsequent lowering of the threshold levels in the future.

Recommendations: Notwithstanding the previous recommendation that assets be removed as one of the criteria for classifying which tier an

entity would fall into, if the Government intends to continue using assets as a criterion, that the minimum level be \$5 million a year. Also, that the threshold for turnover be at the minimum level of \$10 million a year.

- 4.10. Business New Zealand's submission on the FRSC also supported the proposed obligation to prepare statutory financial statements if shareholders with at least 5% of the voting rights give the company direction to do so. This follows the Australian approach. Again, Business New Zealand is pleased to see that this approach has been recommended as part of the determination for which of the three tiers an entity would be placed.
- 4.11. However It has been difficult for business to assess the impacts of the proposed tier 2 reporting requirements, without any detail on what those requirements might be. We understand the part two discussion document to be produced later this year will consider this once the ASRB has further developed proposed disclosure requirements.
- 4.12. The FRA discussion document also proposes the idea of the ASRB or ICANZ developing an optional "best practice" regime for small entities similar to the current exempt companies regime. Business NZ is skeptical whether such a proposal would prove beneficial, despite the regime being optional. Businesses generally receive benefits from compiling financial reports through understanding their current financial position, as well as providing guidance for future planning. Also, other regulatory obligations such as the Companies Act 1993 already provide entities (even at the third tier level) with a basic set of financial reports that they would need to compile. Any best practice guideline draws an automatic line in the sand with what is and is not acceptable in terms of financial reports, which may be too high for many firms to comply with. Despite the regime being optional, as can often be the case with best practice initiatives, they invariably become the standard by which entities must adhere to, and in effect become regulation in everything but name.

Recommendation: That an optional "best practice" regime for small entities does not proceed.

5. Audit and Filing

- 5.1. Given that the FRA currently requires audit and filing only by issuers and foreign companies, any proposed changes need to be carefully considered so that new legislation does not affect a particular group of entities. Business New Zealand agrees that flexibility is the key to determine whether entities are required to audit and file financial statements. Applying auditing and filing requirements solely based on the tier framework would not only be simplistic, but would also be inflexible for the needs of particular entities.
- 5.2. Although auditing provides greater certainty that the financial reports accurately reflect the position of the entity, there should be no doubt that the benefits of auditing outweigh the costs of doing so. While this may be true for most large firms, there would undoubtedly be some ambiguity for small-

medium sized entities. We agree with the views expressed in the discussion document that the likelihood of smaller entities requiring their reports to be audited would be minimal, while the cost would be disproportionately high. Therefore, Business New Zealand would be totally opposed to the idea of all entities being required to audit their financial statements.

- 5.3. Regarding filing of financial statements, again Business New Zealand is totally opposed to the notion of all entities being required to file financial statements. It is suggested there would be overall transparency, monitoring and enforcement benefits but we believe that these are strongly outweighed by the costs involved and the reduction of privacy concerning natural persons, trade secrets or confidential operational information, especially for smaller entities. Also, given the fact that owners/shareholders or stakeholders are entitled to receive reports on the financial status of the entity, compulsory filing requirements are not required to protect their interests. The discussion document closely links the audit and filing requirements, as though they have the same benefit, but the purpose of the two is very different. Owners/shareholders or a stakeholder (for example, a lender to the entity) may require the entity to have audited financial statements but receive no benefit from those financial statements being filed with the Companies Office. This is a key aspect of the report where the compliance costs for business have not been considered and no analysis has been provided on the public benefits of filing of financial information or the costs involved. This appears to be one of the critical concerns of business with this review.
- 5.4. The conclusions in the discussion document take the view that all tier 1 entities should be required to have their reports audited and filed. Business New Zealand disagrees with this view and believes that such decisions should be solely left in the hands of the owners/shareholders, rather than an automatic requirement through legislation. While it may be the case that most, if not all entities that are considered to be a tier 1 entity, get approval or are asked by a proportion of their owners/shareholders to provide audited financial statements, it is not clear that public filing of those financial statements would normally be required. Owners/shareholders are in most instances in a far better position to decide what is best for their entity than Government agencies would. Obviously, this approach would also apply to tier 2 and 3 entities, with the likelihood of following through with auditing and filing requirements decreasing in relation to the tier in which entities are allocated into.

Recommendation: That the option of filing and auditing be based solely on decisions reached by the owners/shareholders and stakeholders of the entity.

- 5.5. Notwithstanding the fact that Business New Zealand would like to see auditing and filing requirements be left in the hands of owners and shareholders or stakeholders to decide, if the Government intends to pursue the view that all tier 1 and 2 entities must have their reports audited and filed, we would be in favour of allowing shifting tier (both up and down) on the basis of owner or shareholder vote.

Recommendation: Notwithstanding the fact that Business New Zealand would like to see auditing and filing requirements be left solely in the hands of owners/shareholders and stakeholders to decide, we would be in favour of allowing shifting tier (both up and down) on the basis of an owner or shareholder vote for auditing and filing requirements.

- 5.6 We also believe further consideration is required on whether audit and filing requirements should be compulsory for closely held companies. The criteria for establishing whether an entity has *reporting responsibilities* is very broad as a result of the inclusion of all entities where there is ‘separation of ownership and management.’ We believe this would generally cover closely held entities, resulting in full tier 1 reporting responsibilities once the size thresholds were met. This view is at variance with the view expressed in paragraph 114 of the discussion document, which suggests that Tier 2 entities would include large closely held companies. It is essential this aspect be further clarified, as it is inappropriate to require large closely held companies to meet the tier 1 reporting requirements.

Recommendation: That further clarification is required of the conditions to establish whether an entity has “reporting responsibilities” to ensure that closely held companies are not included in the definition

6. Entity Neutrality

- 6.1. Business New Zealand does not agree that some form of entity neutrality is desirable in New Zealand. The FRA discussion document points out a justification for entity neutrality whereby two entities that are identical other than say their registered status under the Companies Act means one has a higher required financial reporting level than the other. In our view this is not a strong enough argument for entity neutrality. The legal form of an entity is ultimately decided by the owners/shareholders and they should understand the requirements before accepting a particular form, whether it is the level of financial reporting or otherwise.
- 6.2. We agree with views expressed in the discussion document that entity neutrality would typically result in more rigorous reporting requirements for most entities. Sports clubs and charities are two examples whereby the financial reporting requirements are often performed by volunteers or elected officers of the entity. Entity neutrality would place extra workload on such entities, as well as other smaller-medium sized businesses. Although MED have stated that their own anecdotal evidence suggest many entities already produce financial reports beyond the minimum requirements, at the very least we would want to see a far more rigorous analysis undertaken to determine the extent the level of extra compliance costs entities would have to face if entity neutrality was strongly considered.
- 6.3. In addition, while full entity neutrality for New Zealand would align the country with Australia’s uniform financial reporting requirements regardless of legal form, this does not necessarily mean it would be in the best interest for New Zealand to do so. The fact that both the United Kingdom and Singapore both

have specific statutory instruments requiring registration for specific legal forms shows that there is still scope for differences in reporting between countries.

Recommendation: That a uniform financial reporting regime that encompasses all forms of entity (i.e. entity neutrality) should *not* be introduced.

7. Sector Neutrality

- 7.1. While Business New Zealand does not have any strong views on the issue of sector neutrality, of the three options outlined in the discussion document, Business New Zealand generally agrees with the Accounting Standards Review Board (ASRB) favoured proposal of adapting IFRS for public sector entities.
- 7.2. Business New Zealand does not believe that there need to be any further issues regarding trans-Tasman coordination that need to be considered in this matter.

Recommendation: That the ASRB proposal of adapting IFRS for public sector entities in New Zealand be implemented.