

Regulatory Impact Statement

FINANCIAL REPORTING: MAKING TIERS OF REPORTING

AGENCY DISCLOSURE STATEMENT

This Regulatory Impact Statement has been prepared by the Ministry of Economic Development.

It provides an analysis of options to deal with clarity, service delivery coordination, governance, accountability and independence issues associated with the current framework for setting tiers of financial reporting under the Financial Reporting Act 1993.

The analysis undertaken is conceptual because the costs and benefits cannot be quantified. The key assumption (i.e. the costs and benefits of financial reporting differ depending on the characteristics of the reporting entity) is uncontroversial. The policy can not be implemented until the Bill in which the changes will appear is enacted and brought into force.

One of the rejected policy options could have one of the effects the Government has said will require a particularly strong case before regulation is considered. Option D (Tier-setting by the External Reporting Board, subject to appeal to the High Court) has the potential to impose significant business uncertainty costs. This is the main reason that Option D has not been recommended.

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THE STATUS QUO

- 1 Tiers of financial reporting are needed to recognise that the costs and benefits of general purpose financial reporting (GPFR) vary depending on the different information needs of users and the cost of providing that information relative to the size of the entity providing it and the nature of its business. The tiers must:
 - a Specify the qualifying criteria for each tier; and
 - b Describe, in a broad sense, the financial reporting requirements that will apply for each tier.
- 2 The existing four tiers of reporting were set in three different ways:
 - a Two tiers are defined in the Financial Reporting Act 1993 (FRA) and were, therefore, made by Parliament;
 - b The Framework for Differential Reporting, which provides exemptions from the full standards for certain entities, was jointly created by the Accounting Standards Review Board (ASRB) and the Financial Reporting Standards Board (FRSB), which is a Board of the New Zealand Institute of Chartered Accountants (NZICA). It was issued by the NZICA Council after the ASRB used its power under section 24(1)(d) of the FRA to give directions on accounting policies that have authoritative support; and
 - c Some non-large companies may comply with the domestic standards that applied before International Financial Reporting Standards (IFRS) were adopted (i.e. "Old GAAP"). The ASRB made the Old GAAP tier on the recommendation of the FRSB using its general powers under the FRA.

PROBLEM DEFINITION

- 3 The tier-setting arrangements raise the following clarity, service delivery coordination, governance, accountability, and independence and international credibility issues.

Legal clarity and service delivery coordination

- 4 It is generally desirable for legislation to operate in a way that could reasonably be inferred on a plain reading. However, this is not the case in relation to setting tiers of reporting that are not defined in the FRA. In particular, it is not easily to deduce that the power that was used for setting the Framework for Differential Reporting was intended for that purpose.
- 5 In practice, tier-setting decisions require coordination between the FRSB and the ASRB. To our knowledge, this has not caused any tier-related service delivery problems to date. However, in recent times the ASRB and FRSB have expressed some differing views publicly about the standards that should apply to different tiers in different sectors.

Governance

- 6 The absence of powers for the ASRB to actively produce outputs (including tiers of reporting) effectively mean that it must seek to persuade the FRSB to submit tier-related proposals to it through the standards-setting process. Governance principles would suggest that the peak body (i.e. the ASRB) should make these and other strategic decisions.

Accountability

- 7 Financial reporting standards approved by the ASRB have the force of law and are subject to disallowance by Parliament's Regulations Review Committee. Thus, the ASRB is subject to an appropriate level of accountability in relation to the standards it approves. However, the two tier-related decisions made by the standards bodies in relation to Differential Reporting and Old GAAP were not subject to disallowance or any other specific accountability mechanism.

Independence and international credibility

- 8 The first financial reporting standards systems in most countries, including New Zealand, were established by professional accounting bodies. Over time, it has been seen to be increasingly important for standards setting to be seen to be independent of the interests of the profession. NZICA's central role in making tiers that were not established by Parliament is inconsistent with the contemporary international norm of standards-setting independence.

OBJECTIVES

- 9 The main objective of the proposals in this RIS is to solve the problems identified above and to establish a new framework for setting tiers of reporting that will encourage the decision-maker to make high quality decisions.

OPTIONS

- 10 There is a need to include, in the FRA, a single coherent transparent process for determining the qualifying criteria for each tier of reporting. This function could be carried out by Parliament, the Government or the External Reporting Board (XRB), which will replace the ASRB. The Ministry's discussion document, "The Statutory Framework for Financial Reporting" outlined the following six options for making tiers of financial reporting:
- Option A: Parliament – The tiers would be defined in the FRA;
 - Option B: The Government – The tiers would be defined in Statutory Regulations;
 - Option C: The XRB;
 - Option D: The XRB, subject to appeal to the High Court;

- Option E: The XRB, subject to disallowance under the Regulations (Disallowance) Act 1989. This option would mean that the tiers set by the XRB would be regarded as a Regulation and could be scrutinised by Regulations Review Committee of Parliament. If necessary, the Committee could use its power to recommend to Parliament that the XRB's decision be revoked; and
 - Option F: To give the XRB the power to make recommendations to the Minister, who would be able to accept them, or refer them back to the XRB for further consideration. The Minister would only be able to refer them back if he or she considered that stakeholder consultation had been inadequate or that the proposals were not within the range of acceptable options. Because the grounds for referring back proposals by the Minister would be narrow, the XRB will have the predominant influence on the outcomes of tier-setting processes. However, it would not be able to act unilaterally. The XRB would not be required to obtain Ministerial approval to vary the tiers if the variation corrected a minor error or was otherwise of a minor nature. There would be no Regulations Review Committee scrutiny of the Minister's decisions.
- 11 As noted in Paragraph 1, the tiers of reporting must specify the qualifying criteria for each tier of reporting and generally describe the reporting requirements that will apply. This is relevant to all options. Thus, the impact of setting tiers is that each reporting entity would know which tier of reporting it is in and must comply with the standards that apply to that tier of reporting. The entity must use the recognition and measurement principles and rules that are set out in the relevant set of standards. It must also disclose the information that the standards state must be disclosed and it must present that information in the format that is specified in the relevant set of standards.

ANALYSIS OF OPTIONS

Options A and B: Parliament (an Act) or the Government (Regulations)

- 12 A common disadvantage of these two options is that they would remove the formal linkages between determining which entities have to prepare GPFR and what they would have to prepare. To illustrate why this is a problem, consider what would happen if a tier included two classes of reporting entity which were of significantly different size or whose users had fundamentally different information needs. The XRB would be placed in the difficult position of having to decide whether to approve standards that did not fully meet one set of users' needs, were too costly or too complex or detailed for the other set of users' needs, or a combination of the two.
- 13 Another problem with Options A and B is that they exclude formal involvement by the expert body. The XRB would need to informally seek to influence the outcomes by lobbying the Minister and/or officials. This would be undesirable from transparency and accountability perspectives.

- 14 An additional disadvantage with Option A is that good qualifying criteria that became suboptimal over time (e.g. dollar thresholds) might not be changed until many years later because parliamentary time is scarce and successive governments may regard changing them as a low priority. There are many examples, particularly maximum fine levels that have become too low.

Option C: The XRB

- 15 Option C would deal with the problems associated with Options A and B. However, bearing in mind that the XRB would be exercising the coercive power of the State, Option C is unsatisfactory from an accountability perspective. This is a compelling reason for rejecting this option.

Option D: The XRB, with the right of appeal to the High Court

- 16 Option D would provide the accountability that is missing from Option C. However it has several downsides compared with the two other options that provide accountability (i.e. Options E and F):
- a It will be a more time consuming process and could lead to business uncertainty. Under the other two options, the tiers could be set within a month or so of the XRB finalising its position. The High Court appeal process would take much longer. It could take years if all appeal rights were to be exhausted.
 - b The costs will be greater. There would be opportunity costs for the XRB and the Court. Additional financial costs will arise for such reasons as the need to engage counsel and expert witnesses and the costs related to interim court processes as well as the substantive court proceedings.
 - c There is a risk that the Court would substitute its judgments on subjective matters even if the XRB's judgments on the same matters were not unreasonable, just different. It would be unsatisfactory if the Court were to assume the role of being the de facto decision maker.
 - d There is a risk that preparers' interests would prevail over users' interests in an adversarial court setting. International experience demonstrates that preparers are well organised while users are not. It may place the XRB in the difficult position of having to advocate users' interests. That may be inconsistent with its statutory tier-setting role of balancing the benefits to users against the costs for preparers.

Option E: The XRB, subject to disallowance by the Regulations Review Committee

- 17 The role of the Regulations Review Committee is to examine all regulations and, where it considers appropriate, draw to the House's attention to a regulation if it considers that it is inconsistent with various constitutional principles.

- 18 Option E avoids the disadvantages of Option D. It also has the advantage that the Standing Orders empower the Committee to assess whether the XRB's consultation process has been adequate. However, Option E has two other downsides. First, strongly interested parties, particularly preparers, may seek to influence members of the Committee to challenge XRB decisions. Secondly, as noted above, the Committee does not focus on one of the two issues that matter most in relation to tiers of reporting (i.e. whether the XRB's tiers of reporting are supported by a satisfactory analysis of the costs and benefits).

Option F: The Responsible Minister, on the recommendation of the XRB

- 19 Option F avoids the problems associated with Options A-D. Compared with Option E:
- Option F also creates the potential for lobbying by strongly interested parties. It can be argued that the risk would be greater under Option F because there is a need to lobby only one person. On the other hand, it can be argued that the risks are lower because the Minister is unable to act unilaterally. In addition, lobbying the Minister may be largely ineffective because the grounds for rejecting the XRB's recommendations will be very limited. Our assessment is that it is unclear which of the two approaches is more vulnerable to lobbying by strongly interested parties.
 - Option F is equally good at providing a sound framework for assessing the adequacy of the consultation.
 - Option F provides a much better framework for assessing the adequacy of the XRB's analysis of costs and benefits. The main function of the Regulations Review Committee is to ensure that delegated legislation is not being used to push through government policy initiatives. To that end, the Committee is charged primarily with scrutinising Regulations to ensure that they do not deal with matters of substantive policy, have retrospective application, purport to levy taxes, or contain provisions that purport to amend primary legislation. Evaluating whether an analysis of costs and benefits is not unreasonable does not fit comfortably with these activities.
 - Option F is a better form of safety valve in this case because the safety valve is built into the system for approving the tiers of reporting. The Option E safety valve cannot be used until after the tiers have been set.

CONCLUSIONS AND RECOMMENDATIONS

- 20 Option F is preferred for the following reasons:
- There are major problems with each of Options A-D.
 - Option F is better than Option E for the reasons given in the last two bullet points of Paragraph 19.

CONSULTATION

- 21 All six options were identified as alternatives to the status quo in the Ministry's discussion document entitled "The Statutory Framework for Financial Reporting". The great majority of submissions that addressed this issue supported either Option E or Option F. There was little support for any of the other options.

Specific views

- 22 NZICA favours Option E because it considers that it strikes the right balance between quality of decision-making, cost, accountability, timeliness and regulatory independence. Three of the Big 4 accounting firms submitted on this issue. Pricewaterhouse Coopers and Ernst & Young favoured Option E for reasons similar to those given by NZICA. PwC also stated that the mechanism should be more in the form of a safety valve rather than a requirement for a positive decision by the Minister in every case. Deloitte favoured Option E to avoid the situation where the Minister may be subject to political pressure.
- 23 Of the second tier accounting firms that submitted:
- Option C was supported by BDO;
 - Option E was supported by Hayes Knight, for the reason that Option F risked too much political interference; and
 - Option F was supported by O'Halloran HMT, and Grant Thornton because it would provide accountability without too much political involvement.
- 24 The New Zealand Business Roundtable, the Securities Commission and the Accounting Standards Review Board also support Option F.

IMPLEMENTATION

- 25 The changes agreed to by Cabinet will be included in the Auditor Regulation and External Reporting Bill 2010. Bearing in mind that officials do not control legislative processes, the current milestones are as follows:
- Third quarter of 2010: Introduction
 - Second quarter of 2011: Enactment
 - 1 July 2011: XRB is established

- 26 The ASRB issued a discussion document last year which proposed significant changes to the tiers of reporting, particularly in relation to not-for-profit government entities. It has completed an analysis of submissions and is proceeding on the assumption that changes will need to be made to the tiers, whether using its existing powers or under one of the change options (assuming that Options A or B will not be adopted). The ASRB is planning on the assumption that the XRB will complete its consultation and cost-benefit analysis work by 1 July 2012. The ASRB has indicated to officials that if the legislative deadlines outlined above are met, then it would intend to apply the new tiers of reporting for for-profit and government not-for-profit entities for accounting periods beginning on or after 1 July 2013.

MONITORING, EVALUATION AND REVIEW

- 27 The Ministry of Economic Development will monitor the full range of matters covered in the Bill by seeking feedback from time-to-time from the XRB, NZICA, the Big 4 accounting firms and other stakeholders.
- 28 The Ministry will write to the main stakeholders within two years of the changes being brought into force seeking comments on the reforms. The response to any significant issues will depend on the nature of the issue and whether the changes need to be made urgently. Technical or minor changes will be considered for inclusion in an omnibus bill.