Grant Thornton

An instinct for growth™

Secretariat
Commerce Committee
Select Committee Office
Parliament Buildings
WELLINGTON 6011

Audit

Grant Thornton New Zealand Ltd
L4, Grant Thornton House
152 Fanshawe Street
PO Box 1961
Auckland 1140

T +64 (0)9 308 2570
F +64 (0)9 309 4892
www.grantthornton.co.nz

8 February 2013

Dear Committee Members

Commerce Committee: Financial Reporting Bill 2012

In principle we support this Bill, however there are some aspects of it that seriously concern us.

Our concern principally centres around the lack of consistency in aligning New Zealand requirements with what is currently required in Australia. If the New Zealand Government is seriously committed to creating a Single Economic Market between New Zealand and Australia, then a number of the differences that currently appear in this Bill between our two countries should be removed.

On the one hand, we have a Bill that advocates and justifies many changes on the premise that New Zealand needs to have business legislation that aligns closely with Australia, but on the other the Bill ends up requiring something completely different to be done.

Members of the Select Committee should be aware that in a number of places, the directions outlined in Cabinet Papers and approved by the Government have not found their way into the final legislation and without any explanation as to why. This concerns us.

In in a previous submission we made to this Committee on 10 November 2010 we noted the Bill you are considering right now is viewed by many as a "once in a lifetime" piece of legislation. Given this, in our opinion, it is critical that the legislation that ultimately emerges from this Bill is balanced, fair, and above all else, conforms with the three public policy platforms that are the foundation for this piece of legislation, namely public accountability, economic significance and appropriately addressing the risks present when governance and management of an entity are undertaken by two distinctly different groups of individuals.

This Bill is a complex piece of legislation. It is complex because as Committee members will appreciate, when it comes to financial reporting, one size does not fit all. Additional complexity arises because this Bill has been drafted to apply to all sectors of this country's economy: the for-profit sector, the public sector and the not-for-profit sector. As noted

when the Bill had its first reading in the House on 30 November 2012, these three sectors of our economy have different business and financial needs, and our financial reporting legislation needs to reflect this.

This submission is from Grant Thornton New Zealand. We are an accounting and business advisory firm that has more than 5,000 clients across the country that are both large and small. We are a national firm that currently has offices in Auckland, Wellington and Christchurch; we have 32 partners and we employ approximately 230 staff. Internationally Grant Thornton is now represented in more than 130 countries and we currently have more than 35,000 partners and staff working in our network of firms.

Our major comments on the Financial Reporting Bill that tabled in the House on 31 July 2012 are noted below:

Contracting out of an audit

We are pleased to see there are some entities that cannot contract out of having an audit because they have public accountability. This requirement is consistent with what we currently have in the Financial Reporting Act 1993. In this category of reporting entities we have issuers (of debt and equity financial instruments to the public), local and central Government entities governed by the Public Finance Act 1989 and large overseas companies that carry on business in New Zealand via branches or subsidiaries.

Currently in Australia, only grandfathered former exempt large proprietary companies (the New Zealand equivalent is a large private company) do not have to file their financial statements with their regulator (ASIC)[1]. The previous Minister of Commerce, Simon Power, made it clear that the Government would not use the public policy development principle of "economic significance" to require disclosure of the financial statements of large private companies in New Zealand. On the basis of wishing to be consistent with Australia we accept this decision.

However, in Australia **all large proprietary companies are now required to have an audit** and they cannot opt out of this. Why is this? The explanation we have been given is that the Government in Australia recognises that a large portion of its taxes come from this sector of the economy. By requiring all the entities in this sector to have an audit the Australian Government is effectively putting in place a mechanism and validation process to make sure that all its strategically significant companies are paying an appropriate amount of tax to the Government. It's a reflection of the 80/20 rule: the Australian Government is focusing its audit and financial reporting attention on the entities that make the most significant contribution to its economy.

Another important side benefit of making sure that all large proprietary (ie large private) companies are audited is that when gathering statistical data from these entities, the Australian Government has a greater sense of comfort that the information it is gathering from them can be relied upon because many of the numbers contained in the statistical returns (eg revenue, level of inventory etc) will have been subject to annual scrutiny by an independent auditor.

[1] This was the result of a political decision made back in 1994.

The requirement for all large proprietary companies to be audited is also seen by the Australian Government as important as it looks to encourage inbound investment and portray to the world at large that there is integrity of audit behind the financial statements produced by the largest business enterprises that operate in its economy. Our question to Select Committee members is this: why would New Zealand Government not want to do the same?

While there are a number of large private companies in New Zealand that are subject to audit because their directors recognise the benefit of annual audit, there are many that are not. In fact, we can find no-one in New Zealand who can tell what proportion of large companies are not subject to audit.

What really surprised us was that there was no mention in any of the approved Cabinet Papers that New Zealand and Australia were going to diverge on audit matters. But that is what this Bill has done, and no sound reasons have been given for this departure. To say that large private companies are not in a position to afford the cost of an annual audit in our opinion is a complete nonsense because we are dealing with companies that either have annual revenues greater than $30million per year or total assets greater than $60million.

Another reason we think all large private companies in New Zealand should have an audit is to make sure that sufficient attention is given to the concept of "going concern". Across the country we continue to see a number of large private companies "go under" because they are no longer a going concern. In many instances this has a profound impact on communities around the country.

The benefit of having all large private companies in New Zealand audited is that the audit process does require directors to actively consider the concept of "going concern". Every year when an audit takes place the members of the governing body need to be able to convince their independent auditors that they either are, or are not, a viable enterprise. If they are not, then the auditor is obliged to qualify the financial statements on the basis of going concern.

Over the years, how much wealth in New Zealand has been lost as a result of good money being put into enterprises that were not audited and were no longer a going concern? Auditors view this aspect of their reporting (ie consideration of whether an entity is a going concern) very seriously, but the benefits of this scrutiny are lost if large private companies are given the ability to opt out of having an audit.

Select Committee members may not be aware that under the 1993 Act auditors are specifically required within 7 working days to confidentially report to the Registrar of Companies on every set of company financial statements they have issued a qualified opinion on. While not every qualified opinion relates to going concern, many of them do so and a significant (but unfortunately often hidden) benefit of the audit process is that sustainability concerns cannot be conveniently "swept under the carpet" until the entity's financial circumstances become completely irretrievable (eg Crafar Farms, Ross Asset Management).

Our view is that **all large private companies in New Zealand should be subject to an annual audit** because it requires the directors to deal with the issue of going concern head on, and if they fail to do this appropriately, they can and should be held accountable for their actions by interested external stakeholders.

Opting in and opting out of an audit
Above we have expressed a significant concern about allowing any large private company in New Zealand to opt out of having an annual audit. The Australian Government provides no concessions, and in our opinion, for very good reasons.

However, if the Select Committee disagrees with our view on this, we still think it should ask officials to redraft what is currently in the Bill.

In the 1993 Act there is a currently an option for a company (that is not an issuer or is not overseas owned) to contract out of having an audit, but only if there is a unanimous approval of all the shareholders every year for this to happen.

So this provision in our current legislation requires the involvement of all minority shareholders, no matter what size of shareholding they might have.

However, the Bill as currently drafted changes this.

Section 86 of the Bill (and more specifically 207H (3) of the Companies Act) has been changed and now reads as follows:

> '(3) The shareholders of the company may, at a meeting of shareholders held within the opting period, opt out of compliance with 1 or more of the following provisions in relation to the accounting period by way of a resolution approved by a majority of 95% of the votes of those shareholders entitled to vote and voting on the question:
>
> (a) **sections 201 and 202** (preparation of financial statements and group financial statements):
> (b) **section 207** (audit requirement):
> (c) **section 208** (obligation to prepare annual report).'

Our reading of this clause is that only a majority of shareholders in a large private company (as defined in the Bill) are required to approve an audit. So if there were, say 96% of the voting shareholders involved in voting on whether or not to have an audit, then reading the Bill as currently drafted only a majority (ie 48% or more of them) need to vote against the motion to prevent an audit from taking place. We do not think this low threshold is at all fair on minority shareholders. Without doubt it fundamentally changes what is presently required.

We think the intended change was to allow a company to contract out of having an audit only if 95% (rather than the current 100%) of the voting shareholders agreed annually not to have an audit, but in our opinion it is difficult to infer this intent from what is currently written in the Bill.. So using the example noted in the previous paragraph, if 96% of voting shareholders were present, that at least 91.2% (ie 96% x 95%) of them would have to support the motion not to have an audit to make it effective.

Contrast section 207(H) with what has been drafted in Section 148 of the Bill to replace section 75(3) of the Limited Partnerships Act 2008 where the intention of what needs to happen, in our opinion, has been expressed far more clearly. The wording in this clause requires 95% of the partners who hold capital in the partnership to be involved in the decision of whether or not there is a need to have an audit.

True and fair override

On the matter of dealing with the "true and fair override" members of the Select Committee need to decide whether the provisions that are currently in the Bill will make the audit process more difficult, add more cost, and undermine the comparability and exception reporting process that has been "hard-wired" into the 1993 Act

The current requirements are very clearly spelt out in section 16(1)(g) of the 1993 Act.

Paraphrased into plain English the Financial Reporting Act 1993 as it stands today requires a reporting entity to follow the requirements of GAAP (Generally Accepted Accounting Practice in New Zealand). If the directors of a company believe that the accounting standards that form a part of GAAP generate a nonsense result, then through disclosure the directors can choose to present an alternative accounting treatment. However, if they do this then the directors presenting the financial statements are then required to indicate why they think GAAP is inappropriate and why their alternative presentation and accounting treatment more fairly reflects the circumstances at hand. To round things out, the auditor then needs to indicate whether or not they concur with the alternative presentation that has put forward by the directors of the company.

In our view, the steps that must be followed in the 1993 Act are very clear. Similarly, what the auditor can accept in terms of presenting an alternative presentation on a GAAP matter is also made very clear.

Unfortunately in the Bill as currently drafted there is no equivalent of section 16(1)(g) of the Financial Reporting Act 1993 which reads as follows:

> (g) Whether, in the auditor's opinion and having regard to any information or explanations that may have been added by the reporting entity pursuant to section 11(2) or section 14(2) of this Act, the financial statements and any group financial statements give a true and fair view of the matters to which they relate, and, if they do not, the respects in which they fail to give such a view.

Our understanding of why section 16 (1)(g) was not included is that within International Financial Reporting Standards (that have all been endorsed and approved by our External Reporting Board) there is already an embedded fair presentation override, and so in the view of Ministry officials nothing more needs to be included in the Bill.

Of course the presumption Ministry officials have made is that the application of International Financial Reporting Standards, with additional disclosure when necessary, results in financial statements that achieve a fair presentation. However, this presumption is rebuttable.

IFRS as currently drafted (see IAS 1 *Presentation of Financial Statements* at paragraph 19) makes it clear that in virtually all situations a fair presentation will achieved through compliance with all the standards that have been issued by the International Accounting Standards Board.

However, in the extremely rare circumstance of the directors in a company concluding that compliance with a requirement in IFRS (as approved by the External Reporting Board) would be so misleading that it would conflict with the objective of financial statements, IAS 1 permits a departure from that requirement. However, this is only acceptable if the "relevant regulatory framework requires, or otherwise does not prohibit such a departure"[2].

Today in New Zealand departure from GAAP is specifically prohibited, but in the Bill it will not be.

Because the Bill allows a departure from IFRS an entity will need to explain the facts and circumstances that support this decision. This is achieved by requiring the reporting entity to disclose the following:

(a) That the directors have concluded that the financial statements that have approved for issue present fairly the entity's financial position, financial performance and cash flows;

(b) That it has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve fair presentation;

(c) The title of the IFRS from which the entity has departed, the nature of the departure including:
- The treatment that IFRS would require
- The reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the IASB's (or in New Zealand's case, the External Reporting Board's) Framework; and
- The treatment adopted.

(d) For each period presented, the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement; and

(e) When there has been a departure from a requirement of an IFRS in a prior period, and that departure affects the amounts recognised in the financial statements for the current period, the disclosures set out in (c) and (d) above.

Grant Thornton has carefully considered the pros and cons of changing what is currently in the Bill and we think that what is in the Bill is acceptable. Yes, there was a period some 20 years ago before the introduction of the 1993 Act where the true and fair override was abused, but we think that time and events have moved on. Certainly the quality of standard setting has greatly improved and so much better standards are being issued.

---

[2] See IAS 1 *Presentation of Financial Statements* paragraph 19.

However, others will say that the legislation as currently drafted is still working satisfactorily, it isn't broken, so why change it?

Our recommendation to the Select Committee is that they widely canvass the pros and cons of changing what in currently in the Bill as our impression is that there are differing views within the accounting profession in New Zealand on what the most appropriate treatment should be.

Timeframe to complete financial statements

Of concern to a number of New Zealand businesses will be the reduced reporting deadlines for entities that are required to prepare general purpose financial statements.

We note that the requirements in the Bill effectively mirror the requirements noted in Australia legislation, namely that four calendar months after each balance date the financial statements need to the approved, audited and, when applicable, filed with the Registrar of Companies.

We believe the concept of timeliness is critically important when it comes to preparing financial statements, particularly when general purpose financial statements are being prepared. Given this we support what is included in the Bill (ie three months to complete and approve the accounts and then another 20 working days in which to register and file them with the Registrar of Companies). At this stage we would not like to see the completion deadlines reduced any further.

The inclusion of registered charities

We are pleased to see for the first time the financial statements of registered charities included in this Bill. We see this development as a progressive step as in the past there have been instances where donors have been surprised to subsequently discover that their donations have not been spent on what they had expected, leaving a sense of disillusionment and mistrust. Our view is that any organisation, not just registered charities, which raises money from public donations should be required to account for all the funds it has received. We therefore encourage the Government and the Law Commission to press on with proposed financial reporting reforms for incorporated societies and the like.

We are aware that Ministry officials have issued a consultation paper on what the size thresholds should be for the audit of registered charities. We would like to see the outcome of these deliberations reflected in this piece of legislation, as we believe this is the piece of legislation that should provide that direction.

Resignation of the auditor

There are process differences between Australia and New Zealand in dealing with the resignation of an auditor. In summary the Australian process is more tightly defined and regulated than we have in New Zealand.

Our view is that a high degree of transparency should surround the resignation of an auditor, and so we would like to see all of the requirements outlined in Australian legislation replicated here in New Zealand on the basis of harmonisation.

Annual reporting thresholds

An important aspect of this Bill is to ensure there are appropriate safeguards for investors in companies that have 10 or more shareholders. Similarly there are audit and annual reporting concessions for companies that have fewer than 10 shareholders.

The concern we have with the Bill in its current form is that it is silent in relation in relation to "look through" arrangements. Contrast this with the Income Tax Act 2007 that takes the concept of "look through" actively into consideration.

We wish to use an example to illustrate how the proposed legislation might be "gamed" by reporting entities. The objective in this scenario is to keep compliance costs to a minimum and therefore to remain as a company that has less than 10 shareholders. Assume that Company A has 8 independent shareholders. The company wants to expand via the injection of equity capital and so 4 new shareholders are found. However, they combine their investments through forming another company, called Company B. In this situation, does Company A have 9 shareholders (ie 8 individuals and one company) or 12 shareholders (and thus finds itself captured by the reporting governance requirements of a company with 10 or more shareholders?)

Clarification in the Bill of this type of circumstance would, in our opinion, be very helpful.

Group financial statements

We support the proposal to no longer require the preparation of parent company financial statements if group financial statements are also prepared because it will bring New Zealand companies into line with what is permitted in Australia.

We draw to the Select Committee's attention that a consequence of this change is that fewer related party transactions will be disclosed than is presently the case. Our regulators, particularly the Financial Markets Authority, the Serious Fraud Office and Inland Revenue have a keen interest in fully understanding the consequences and extent of related party transactions as their disclosure in a set of financial statements can quickly highlight operational dependencies that exist within a group.

While shareholders have limited access to related party transaction by having access to disclosures in the interests register, other parties (eg creditors and lenders) do not. We therefore put to the Select Committee whether some consequential change to annual reporting requirements (outlined in the Companies Act 1993) are now required to ensure that all stakeholders in a company are not denied access to related party information that could prove to be very valuable in deciding whether or to make an investment or do business with another entity.

Size criteria

We have noted that the size criteria noted in this Bill is currently significantly higher that what is presently required to be followed in Australia[3]. We also note that in Australia there is also currently a number of employees test to be considered (which is not going to be a component part of the determination of large in New Zealand legislation).

Given the level of Trans-Tasman business activity that currently takes place (approx. 28% of this country's annual GDP) we would like officials in Australia and New Zealand align their size criteria, and when any changes are subsequently made to asset and revenue thresholds, that the timing of these changes is also aligned. Certainly the removal of the number of employees from the size is questionable, since employees of a company are usually seen as significant stakeholders.

Amendments to the Partnership Act 1908

It is hard to believe that New Zealand still has legislation for partnerships that was first enacted 105 years ago. That said, the proposed changes to require large partnerships to prepare financial statements in accordance with GAAP in our view is long overdue, and we whole-heartedly support the decision to extend the Bill to ensure these types of entities are captured.

Why does this Bill not include trusts?

As noted above, while the Bill now addresses partnerships, a question we have for the Select Committee is how much longer are financial reporting requirements for trusts (or should we say lack of financial reporting requirements) going to remain? Our concern is a policy based one based on economic significance and separation of ownership and management. As Select Committee members may be aware there are huge number of trusts in New Zealand (some estimate as many as 200,000 trusts) that own billions of dollars of assets and generating significant revenues that are not currently under the umbrella of the Financial Reporting Act.

We think now is the time for change and so we believe Select Committee members should now ask Ministry officials when are trusts intended to be covered by this important piece of legislation?

Amendments to Retirement Villages Act 2003

We have a concern about a large number of retirement villages no longer being defined as issuers.

As New Zealand's population continues to age a greater percentage of the population will be moving into retirement villages. When this happens significant amounts of money will be invested in retirement villages and we believe that these "mum and dad" investors need to be fully protected.

---

[3] In Australia the current threshold test is that two of the following three size criteria must be exceeded to be considered "large". The three criteria are: Revenues greater than $25million per annum, total assets greater than $12.5 million and more than 50 (full time equivalent) employees. Compare this to what is in the Bill where you are large if you exceed either one or the other of the following two criteria: total assets greater than $60 million or revenues exceeding $30 million per annum in the two years preceding the year that is about to be reported on.

While we accept that many of the residents (or potential residents) of retirement villages may not be able to fully understand all the disclosures an issuer is required to make, what New Zealand currently has is a level playing field in terms of financial reporting disclosures. We think this should continue.

If this Bill is passed some retirement villages will have to continue to report as issuers (eg MetLife, Ryman, Summerset), but many others will not. While we accept there may be some reduction in audit compliance costs for residents of existing retirement villages that fall into Tier 2, the identified compliance cost savings from retirement villages no longer being classified as issuers, in our opinion, will be minimal.

Our view is that professional advisors assisting individuals looking to invest in retirement villages (ie lawyers and accountants) should continue to be provided with financial statements for an issuer that has been audited by an auditor licensed under the Auditor Regulation Act 2011.

For this reason we do not support the relaxation of any of the current financial reporting requirements(ie from Tier 1 to Tier 2) or the auditing requirements (by a licensed auditor with the Financial Markets Authority rather than one that is not) for retirement villages.

Special purpose financial reporting for small and medium sized companies

We support the proposal to alleviate more than 450,000 companies from the burden of having to prepare general purpose financial statements. We think the alternative requirements that are reflected in the Bill are fit for purpose and should work well in a New Zealand context.

Our firm will actively market the consequences of so many companies no longer having to prepare general purpose financial statements, as we think the changes noted in the Bill are still not widely known about.

Changing balance date

Section 40 of the Bill confirms that the default balance for a reporting entity shall be "the close of 31 March or any other date that the directors of the entity adopt as the entity's balance date with the approval of the Commissioner of Inland Revenue." This is a change from what is currently in section 7 of the Financial Reporting Act 1993 that says "the term balance date in relation to an entity means the close of the 31st day of March or such other date as the directors of the entity adopt as the entity's balance date."

Anecdotal evidence provided to us indicates that getting Inland Revenue approval for a change of balance date can take quite some time to secure and on occasion has been rejected. Our view is that seeking the involvement of the Commissioner of Inland Revenue is creating an unnecessary step. There are many companies formed in New Zealand that are subsidiaries of overseas companies. We recommend that the legislation only require the approval of the Commissioner of Inland Revenue if the balance date of the New Zealand entity if different from that of its ultimate parent, or the balance date is being changed 15 months after the date of an entity's formation or incorporation. Put another way, our impression is that section 7 of the 1993 Act has worked well for New Zealand over the last 20 years, so why change it?

Grant Thornton
An instinct for growth™

Compliance with Non-GAAP standards

We are pleased to see the Bill making provision for the imminent release of financial reporting standards that do not relate to traditional accounting matters such as integrated reporting. However, if an entity fails to comply with a Non-GAAP standard issued by the External Reporting Board in the future will there be any financial penalties associated with it?

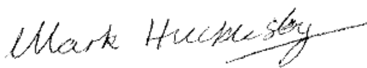
We think there should be, because giving financial reporting standards the force of law, whether or not they are defined as Non-GAAP should, in our opinion, require full compliance and there should be appropriate consequences for failing to recognise them.

Other matters

We would like the opportunity to appear before the Select Committee to elaborate on some of the more important concerns we have noted with this Bill.

Should you have any questions in the interim, please do not hesitate to call us

Yours sincerely



Mark Hucklesby
National Technical Director
T: 09 308 2534
E: mark.hucklesby@nz.gt.com

Brent Kennerley
National Director, Audit
T: 04 495 3771
E: brent.kennerley@nz.gt.com