

24 February 2005

Review of Financial Reporting Act
Ministry of Economic Development
PO Box 1473
WELLINGTON

Attention: Mr Matthew Farrington

Review of the Financial Reporting Act Part II

We are grateful for the opportunity to comment on the Ministry's discussion document, *Review of the Financial Reporting Act Part II*.

The review document canvasses a number of issues:

- The reconstitution of the Accounting Standards Review Board as a Crown entity, with a broader range of functions in relation to the setting and enforcement of accounting standards. This proposal would complete the progressive nationalisation of the setting and enforcement of mandatory accounting standards. Prior to the enactment of the Financial Reporting Act 1993 (FRA) compliance with accounting standards was voluntary and the accountancy profession set the standards. Disclosure requirements imposed on issuers and public companies were modest (though more extensive than those that applied before the Securities Act 1978 and the Companies Act 1955 respectively came into force). Financial accounts were required to meet certain general principles, such as the 'true and fair' test, rather than the increasingly detailed and prescriptive standards that apply at present.
- The discussion document considers the possibility of setting standards for non-financial performance measures, most notably the so-called triple bottom line report, and appears to endorse such a development.
- The specification of entities that are required to produce financial reports that comply with the FRA would be removed from the FRA and inserted in other relevant legislation such as the Companies Act 1993.
- The discussion document proposes to extend the obligation to prepare audited financial reports and to file them. The Ministry proposes that "large, economically significant" companies that do not issue securities to the public (non-issuers) be required to file their financial reports (that is, make them available for public inspection). Under an alternative option such companies would not be required to file their financial reports if their shareholders so resolved. Overseas incorporated companies that operate in New Zealand as a branch would be subject to reporting requirements but they would be permitted to apply for an exemption in certain circumstances. The reporting and auditing requirements imposed on charities would be expanded.
- The question of whether audit standards should be subject to the same oversight as accounting standards is raised.

The Ministry states that its primary goal in reviewing the FRA is to ensure that New Zealand's financial reporting regime is "optimal for current circumstances and strikes an appropriate balance between the costs and benefits of financial reporting." However, as with other reviews relating to financial reporting and the disclosure of financial information, including the proposal to introduce the FRA in 1992, the analysis reflected in the discussion document is far too narrow and insufficiently rigorous.

The discussion of institutional arrangements (first bulleted paragraph above) largely consists of a survey of other jurisdictions and the observation that it is critical that the standard setter is independent and the standard setting process is transparent. The discussion document states that present arrangements could be perceived to unduly favour the accounting profession. It does not state who holds such perceptions, whether such perceptions are warranted, or even whether they are of any significance. More importantly, there is no comparative evaluation of alternative institutional arrangements for standard setting, including voluntary arrangements.

A Crown entity is not immune from political and other pressures. The recent controversy surrounding the New Zealand Qualifications Authority, which is a Crown entity, illustrates this point. Thus the issue of independence, perceived or otherwise, is not eliminated by the government taking responsibility for all aspects of setting accounting standards through a Crown entity. Similarly, the argument that the proposals are justified because accounting standards affect the public sector is unconvincing. The requirements of the public sector should not dictate the standards imposed on a family-owned business or a private charity. The government could, if it wished, make separate arrangements for the public sector.

The question of whether financial reporting and accounting standards should be mandatory should be examined on a first principles basis as key aspects of the review of the FRA. As far as we are aware no such examination has ever been undertaken. Moreover, we understand that no proper analysis of the merits of making international accounting standards mandatory has been prepared. Although enterprises that operate within an international environment tend to be large, the vast majority of companies are owned and financed locally. The arguments that are commonly advanced for adopting international accounting standards are not applicable to them. It is incumbent on the promoters of such policies to demonstrate that they are welfare-enhancing.

Our submission on the Bill that led to the FRA (copy attached) concluded that a compelling case for mandatory disclosure had not been made. Further, we were sceptical that such a case could be established. In a 1997 report for the New Zealand Business Roundtable, Professor George Benston argued that voluntary disclosure was preferable in the context of the investment product and adviser disclosure proposals. Many of the arguments discussed in his report are relevant to the mandatory disclosure of financial reports and non-financial information. (A copy of Professor Benston's report is attached.)

The discussion on setting standards for non-financial reporting is perfunctory. The proposal implied by the discussion document would expand substantially the role and extent of mandatory reporting standards and would impose large costs on affected entities. The net benefits of such standards, which have not been identified, let alone assessed, are likely to be negative and non trivial.

The discussion of non-financial standards and some other aspects of the discussion paper appear to be predicated on an acceptance of the doctrine of corporate social responsibility. No regard is had to the growing literature that argues that that doctrine has the potential to reduce community well-being and undermine the market economy which has produced wealth on an unprecedented scale. Professor David Henderson is a leading contributor to the literature. A copy of his report for the Business Roundtable, *Misguided Virtue: False Notions of Corporate Social Responsibility*, is enclosed, as is a recent survey from *The Economist* which we have permission to reproduce. It has a similar thrust to Professor Henderson's report.

In a submission on the discussion document which we have seen, Foodstuffs examines thoroughly, within a contemporary public policy framework, whether non-issuers should be required to file financial reports. Foodstuffs conclude that the benefits of the proposed mandatory financial reporting are unlikely to outweigh the costs, which include issues of privacy, commercial confidentiality, property rights and the costs of administration and compliance. The Business Roundtable endorses Foodstuffs' submission and its conclusions.

Yours faithfully

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