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## Improving financial reporting in the public sector



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# Improving financial reporting in the public sector

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Representatives under section 20 of  
the Public Audit Act 2001.

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# Dedication

This report is dedicated to Tony Dale and Kevin Simpkins, without whom the recent history of New Zealand accounting would be very different.

Tony was the chief executive officer of the External Reporting Board (XRB) and one of our alumni. During the last five years or so, Tony devoted his energy to the new Accounting Standards Framework, which is the subject of this report. New Zealand now has accounting standards for public benefit entities because of Tony's intellect, passion for the public sector, and unflagging work to improve accounting here and throughout the world.

Kevin was the Deputy Controller and Auditor-General from 2002 to 2005. He was one of the gurus of accounting in New Zealand and internationally. He served on a significant number of accounting boards and committees here and abroad. Kevin was the first chairman of the XRB and was responsible for developing the new Accounting Standards Framework in New Zealand. Kevin had the vision, drive, and mana to lead a significant change to financial reporting in New Zealand.

Tony and Kevin will be sadly missed.



**Tony Dale**  
*3 October 1959 – 16 April 2015*



**Kevin Simpkins**  
*16 January 1958 – 24 October 2015*

# Contents

Auditor-General's overview	4
Part 1 – Financial reporting in the public sector and why it matters	6
General purpose financial reports	7
Requirements for public entities to produce general purpose financial reports	8
Importance of an independent standard-setting process	9
Who sets the accounting standards?	9
Structure of this report	10
Part 2 – Changes in accounting standards for the public sector	11
Changes in accounting standards from 1993 to 2009	11
How accounting standards were set from 1993 until late 2002	11
Our concerns about the suitability of International Financial Reporting Standards for the public sector	14
Advocating for a new approach	15
Part 3 – Significant changes since 2009	17
External Reporting Board set up in July 2011	17
Proposals for new Accounting Standards Framework agreed in April 2012	18
Reporting under the new accounting standards from July 2014	20
Different accounting standards for public benefit entity reporting in Australia	20
New State sector and public finance legislation	21
Part 4 – Have the changes resolved our concerns?	23
Overall, changes are encouraging	23
Positive changes in the new Accounting Standards Framework	23
Good platform for future financial reporting	25
Part 5 – Challenges arising from the new accounting standards	26
Our concerns about some of the substantive changes	26
Other implementation issues	28
Part 6 – Where next for financial reporting in the public sector?	29
Continuing to focus on user needs	29
Helping users understand the inherent uncertainties	30
Focusing on what matters most	30
Reducing the number of reporting entities	31
Keeping pace with technology	32
Figures	
1 – Information provided in general purpose financial reports	7
2 – International and New Zealand independent accounting standard-setting boards	10
3 – Timeline of the development of accounting standards in New Zealand, 1993 to 2009	12
4 – Principles of International Financial Reporting Standards that were unsuitable for public benefit entities	14
5 – Assessment of four approaches for setting accounting standards for the public sector	15
6 – Timeline of significant changes to accounting standards in New Zealand since 2009	17
7 – Features of the new Accounting Standards Framework	19

# Auditor-General's overview

Since International Financial Reporting Standards were implemented in New Zealand, my Office has been calling for changes in how the accounting standards that affect most of our public entities are set.

My predecessor, Kevin Brady, was concerned that the International Financial Reporting Standards – designed for commercial companies listed on stock exchanges – were not suitable for much of our public sector. In 2009, he published a discussion paper, *The Auditor-General's views on setting financial reporting standards for the public sector*, to inform Parliament of his concerns.

In this report, I reflect on the concerns raised at that time, set out my views about how well those concerns have been addressed, and provide some insight into the future of financial reporting.

I am pleased to report positive changes to accounting standards during the last six to seven years, which I expect to lead to improvements in financial reporting. The changes mean that we now have a tailored approach to financial reporting in the public sector and a foundation for much better reporting in future.

The positive changes include setting up an independent body to set accounting standards, the External Reporting Board (XRB), and adopting a new Accounting Standards Framework for all reporting entities.

The new Accounting Standards Framework is designed so that financial reports will better meet the needs of users. The Framework distinguishes between accounting standards for public benefit entities and those for commercially focused entities, both of which are applicable to the public sector.

The Framework also uses tiers so that financial reporting requirements reflect the different size and nature of reporting entities in New Zealand. The tiered structure is likely to help smaller entities achieve a better balance between the costs and benefits of general purpose financial reporting. I encourage all public entities to take full advantage of any financial reporting concessions that are available in the new tiered structure.

During the same period, there have also been legislative changes designed to make financial reporting by public entities more useful and more relevant, with a view to improving accountability and decision-making.

Overall, I am encouraged by the changes that have occurred since 2009. These changes better position the public sector to report more meaningfully in the future. However, public entities need to take advantage of the flexibility available within the new Accounting Standards Framework by focusing on users' information needs and what matters most.

The way is open for public entities to change the focus of their reporting from complying with specific accounting standard requirements to communicating better through their financial reports. During the last six years, I have strongly supported the “decluttering” of financial statements. Those who prepare financial statements need to think about and include only the information that is necessary for users’ understanding.

The XRB also has an important ongoing role in helping to resolve some of the more challenging areas in general purpose financial reporting.

I hope that this discussion paper will promote further constructive debate about the future of financial reporting in the public sector, so that reporting by public entities can continue to evolve to better meet the information needs of users.

A handwritten signature in black ink, appearing to read 'Lyn Provost', written in a cursive style.

Lyn Provost  
Controller and Auditor-General

24 February 2016

# 1

## Financial reporting in the public sector and why it matters

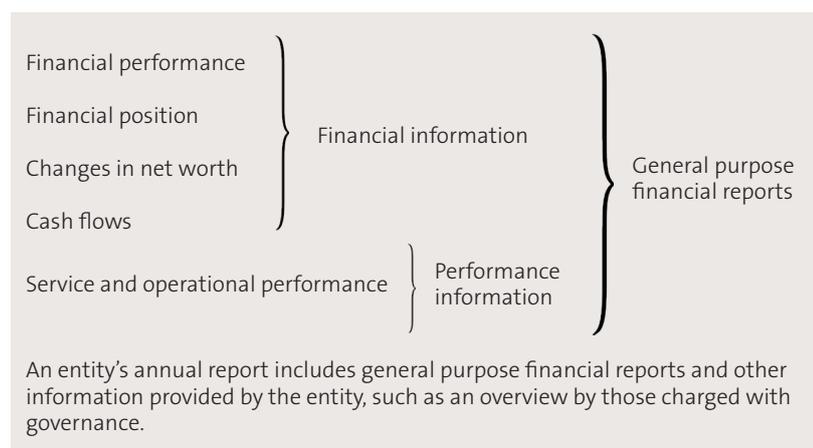
- 1.1 In this Part, we discuss financial reporting in the public sector, including the importance of independent standard-setting.
- 1.2 Financial reporting is how public entities account for their stewardship of – that is, the care they take with – public money and other assets.
- 1.3 Financial reporting helps in decision-making and in increasing accountability, openness, and transparency. It also helps to improve the performance of, and trust in, the public sector.
- 1.4 Each year, my Office audits more than 3800 public entities, from large government departments to small rural schools and cemeteries. Our 2014/15 work programme theme, *Governance and accountability*, reflects the importance of public entities operating and accounting for their performance in the way that Parliament intended.
- 1.5 The public sector is made up of a diverse range of organisations and agencies, including government departments, local authorities, Crown entities, State-owned enterprises, district health boards, tertiary education institutions, schools, and cemetery trusts. There are also public entities outside these broad categories, such as the Reserve Bank of New Zealand.
- 1.6 Many public entities are funded by money from taxpayers, ratepayers, donors, local and overseas investors and lenders, and others to achieve their intended outcomes. Public entities are accountable to the providers of money and to the recipients of the goods and services the entity delivers.
- 1.7 The primary objective of most public entities is to deliver services to the public rather than to generate a commercial return for investors. These entities are referred to as **public sector public benefit entities**.
- 1.8 Some public entities have a greater focus on achieving a commercial return. These entities are referred to as **public sector for-profit entities**. They include State-owned enterprises (such as New Zealand Post Limited), mixed ownership model companies (such as Mighty River Power Limited), and Crown Research Institutes (such as National Institute of Water and Atmospheric Research Limited).
- 1.9 As well as having entities with different purposes, the public sector also has several different ownership and governance models. For example, a local authority represents the interests of a particular community, while mixed ownership model companies have both private sector and public sector shareholders.

- 1.10 In all instances, people outside the public entity are interested in, and/or need to know, how the public entity is spending the money it manages. This includes knowing whether the entity is performing effectively to achieve what was intended with the money.

## General purpose financial reports

- 1.11 Financial reports provide basic information to people interested in the performance of an entity (the users).<sup>1</sup> They allow the entity to be held accountable for how it manages and uses the money it receives.
- 1.12 Many individuals with an interest in the performance of a public entity do not have the power to require the entity to produce customised financial or performance information. Instead, they rely on the **general purpose financial reports** that public entities provide.
- 1.13 General purpose financial reports are designed to provide financial and, where required, performance information to a range of users. To be relevant, the information must meet the accountability and/or decision-making needs of the users.
- 1.14 Figure 1 shows the information that general purpose financial reports provide.

**Figure 1**  
**Information provided in general purpose financial reports**



1 Users of financial reports include citizens, resource providers, and service recipients or their representatives (including members of Parliament, statisticians, analysts, the media, financial advisors, public interest and lobby groups, regulators, trustees, and rating agencies).

- 1.15 Users of a public entity's general purpose financial reports might want to find out about:
- the goods and services the entity has delivered;
  - what the entity has achieved;
  - revenue generated and expenses incurred by the entity;
  - the level of assets the entity controls and the liabilities it has incurred;
  - the amount of equity the entity has; and
  - other matters that help users to understand the entity's financial position and performance.

### Requirements for public entities to produce general purpose financial reports

- 1.16 Most public entities are formally required to produce general purpose financial reports. The requirement to do this can be set by legislation, founding documents (such as trust deeds), the parent entity, or the responsible Minister. Entities can also decide to prepare these reports, if they think that doing so would be useful.
- 1.17 Usually, legislation requires that the information in general purpose financial reports must comply with **generally accepted accounting practice** (also known as GAAP).
- 1.18 Generally accepted accounting practice is the overall body of accounting standards and other guidance that sets out how an entity should prepare general purpose financial reports. Importantly, generally accepted accounting practice is a set of objective principles and requirements that are not subject to the preparer's individual preference.
- 1.19 General purpose financial reports are more likely than other reports to be reliable because of the requirement to comply with generally accepted accounting practice.
- 1.20 It is important that independent standard-setters carefully consider the requirements for preparing general purpose financial reports to ensure that the reports are based on consistent, unbiased, and transparent accounting standards.
- 1.21 In the public sector, the Auditor-General provides assurance to users that the information a public entity reports materially complies with these accounting standards and fairly presents the performance of the entity for the period that the financial report covers.

## Importance of an independent standard-setting process

- 1.22 An independent standard-setting process helps to ensure that accounting standards are high quality and, when applied, result in reported information that meets the needs of users. Without an independent standard-setting process, accounting standards could be poorly thought through and unduly influenced by special interest groups.
- 1.23 The main elements that contribute to an effective, independent process for setting accounting standards include:
- selecting independent members of the standard-setting body who have an appropriate level of technical expertise and experience;
  - monitoring the performance of members of the standard-setting body;
  - having a policy about managing conflict of interests;
  - holding public meetings to allow views to be heard;
  - having an oversight process that supports the public interest;
  - giving the standard-setting body adequate resources and technical support; and
  - having a transparent process to identify and prioritise changes to accounting standards.

## Who sets the accounting standards?

- 1.24 Two international boards set global accounting standards – the **International Accounting Standards Board** and the **International Public Sector Accounting Standards Board**. They create accounting standards for for-profit and public benefit entities in both the public and private sectors. The International Accounting Standards Board created the International Financial Reporting Standards (IFRS), and the International Public Sector Accounting Standards Board created the International Public Sector Accounting Standards (IPSAS).
- 1.25 In New Zealand, the **External Reporting Board** (XRB) prepares and issues accounting, auditing, and assurance standards and guidance. The XRB is an independent Crown entity. The Governor-General appoints its Board on the recommendation of the Minister of Commerce. However, the XRB's work is not subject to direction from the Government. It prepares accounting, auditing, and assurance standards independently of the professional bodies for accountants in New Zealand and Australia.
- 1.26 Figure 2 shows the different roles of the independent standard-setting bodies and the accounting standards that they set.

**Figure 2**  
**International and New Zealand independent accounting standard-setting boards**

	<b>International Accounting Standards Board</b>	<b>International Public Sector Accounting Standards Board</b>	<b>External Reporting Board (New Zealand)</b>
<b>Overall purpose</b>	To provide the world's international capital markets with a common language for financial reporting.	To serve the public interest by creating high-quality accounting standards for use by public entities around the world.	To set accounting, auditing, and assurance standards for use by New Zealand entities.
<b>Standards designed for</b>	For-profit entities.	Public sector public benefit entities.	For-profit and public benefit entities.
<b>Name of standards the Board is responsible for</b>	International Financial Reporting Standards.	International Public Sector Accounting Standards.	New Zealand equivalents to International Financial Reporting Standards.  Public Benefit Entity accounting standards.

## Structure of this report

- 1.27 In Part 2, we describe the changes in accounting standards in the public sector from 1993 to 2009. We also set out the concerns that we, and others, raised in 2009. In short, those concerns were that accounting standards set for much of the public sector were unsuitable because they were designed for the private sector.
- 1.28 In Part 3, we outline the significant changes since 2009, including setting up the XRB, the new Accounting Standards Framework, accounting standards for public benefit entities (PBE accounting standards), alignment of accounting standards with international standards, and legislative reforms.
- 1.29 In Part 4, we discuss whether the changes since 2009 have resolved our concerns. In Part 5, we discuss the challenges arising from the new accounting standards. In Part 6, we discuss next steps for financial reporting in the public sector.

# Changes in accounting standards for the public sector

- 2.1 In this Part, we summarise how accounting standards and financial reporting in the public sector changed from 1993 to 2009. We also set out the concerns that we and others expressed in 2009 about using accounting standards that were not suitable for much of the public sector.

## Changes in accounting standards from 1993 to 2009

- 2.2 In 2009, the then Auditor-General, Kevin Brady, published a discussion paper to make Parliament aware of our concerns about accounting standards for the public sector.<sup>2</sup> These concerns arose because of the way that accounting standards had been changing since 1993.
- 2.3 Figure 3 shows the main changes in accounting standards from 1993 to 2009.

## How accounting standards were set from 1993 until late 2002

- 2.4 In 1993, the Accounting Standards Review Board was set up as an independent Crown entity. It had limited resources and functions, and its part-time members met only a few times each year. One of its main functions was to review and approve accounting standards.
- 2.5 From 1993 to 2002, the Financial Reporting Standards Board, a committee of the then New Zealand Institute of Chartered Accountants,<sup>3</sup> wrote the accounting standards.<sup>4</sup>
- 2.6 The Accounting Standards Review Board approved accounting standards proposed by the Financial Reporting Standards Board, as it saw fit, for specified reporting entities to apply when preparing general purpose financial reports. Accounting standards approved by the Accounting Standards Review Board had legal status. Therefore, the two Boards had to co-operate to set accounting standards.
- 2.7 The accounting standards that were created, known as Financial Reporting Standards, took into account the nature of the different entities that would apply the standards. That is, when determining the requirements of Financial Reporting Standards, the standard-setters took account of the different type of entities in the public sector, the not-for-profit sector, and the private sector, regardless of size.

2 Controller and Auditor-General (June 2009), *The Auditor-General's views on setting financial reporting standards for the public sector*, Wellington.

3 The New Zealand Institute of Chartered Accountants amalgamated with its Australian equivalent in 2014. The new entity is known as Chartered Accountants Australia and New Zealand.

4 Our Office had a representative on the Financial Reporting Standards Board until 2008.

- 2.8 Taking account of a broad range of entities meant thinking about a broad range of transactions and a broad range of information needs for the users of general purpose financial reports.

**Figure 3**  
**Timeline of the development of accounting standards in New Zealand, 1993 to 2009**



- 2.9 As well as taking account of the broad range of entities, Financial Reporting Standards were typically written using language that was appropriate for all reporting entities, whether they were in the public, not-for-profit, or private sectors. These standards could fairly be described as “sector neutral” because they were written with the full range of entities in mind.

## Decision in late 2002 to introduce International Financial Reporting Standards

- 2.10 In December 2002, the Accounting Standards Review Board decided that all reporting entities in the public and private sectors would apply new accounting standards based on International Financial Reporting Standards (IFRS).
- 2.11 The International Accounting Standards Board designed IFRS to improve profit-oriented entities' access to international capital markets. Financial statements prepared in different jurisdictions would be directly comparable because they would use the same set of accounting standards.
- 2.12 IFRS were first adopted by entities with financial reporting obligations listed on the European stock exchanges and entities subject to the Australian Corporations Act 2001, for reporting periods beginning on or after 1 January 2005.
- 2.13 When New Zealand adopted accounting standards based on IFRS, some limited changes were made to IFRS. The adapted standards were called New Zealand equivalents to International Financial Reporting Standards (NZ IFRS). Like Australia, New Zealand applied its IFRS-based accounting standards to all reporting entities, including public benefit entities, rather than only to profit-oriented entities listed on stock exchanges.
- 2.14 The initial view of the Accounting Standards Review Board was to adapt IFRS for reporting entities in the for-profit sector, the public sector, and the not-for-profit sector. However, because of concerns that changes to IFRS could compromise its integrity, including how the standards might be interpreted, the Accounting Standards Review Board decided to limit the adaptation.
- 2.15 Many, including the then Auditor-General, considered that the limited adaptation of IFRS to NZ IFRS did not produce accounting standards that were appropriate for public benefit entities. One of our concerns was that a large number of documents were issued for consultation in a relatively short period of about 12 months. We were also concerned that the standard-setter was reluctant to add guidance for public benefit entities.
- 2.16 Not surprisingly, with attention and resources focused on adopting and adapting IFRS, many important issues with public sector reporting did not receive the attention they needed. For example, little progress was made with a standard on reporting service performance information.
- 2.17 Nevertheless, an initial suite of NZ IFRS was completed in late 2004. This meant that there was a "stable platform" of accounting standards available for entities that chose to apply NZ IFRS for reporting periods beginning from 1 January 2005.

The stable platform represented a significant milestone. Notwithstanding the overarching concerns expressed by the main stakeholders, the roll-out of the accounting standards generally reflected well on those involved in adapting IFRS to NZ IFRS.

## Our concerns about the suitability of International Financial Reporting Standards for the public sector

- 2.18 We expressed two general concerns about adapting IFRS for the public sector. These were:
- the complexity of the requirements in NZ IFRS, particularly for smaller public entities, and;
  - the difficulty associated with applying many of the requirements in NZ IFRS to public benefit entities.
- 2.19 IFRS were built on several fundamental principles that, mainly, do not apply to public benefit entities. Figure 4 sets out the fundamental principles of IFRS and includes comments on their suitability for public benefit entities.

**Figure 4**  
**Principles of International Financial Reporting Standards that were unsuitable for public benefit entities**

Underlying assumptions of IFRS	Suitability for public benefit entities
Entities have an over-riding profit-seeking objective.	Public benefit entities have an overall objective of providing goods and services for community or social benefit.
Transactions are invariably exchange in nature.	Many of the transactions of public benefit entities are non-exchange in nature.
Markets exist for these transactions to take place.	Markets often do not exist. Public benefit entities hold many specialised assets and have obligations that cannot be readily transferred to third parties.
Asset values are largely arrived at by referring to future cash flows.	An assessment of value needs to take account of the nature and purpose of the entity (that is, to deliver future services to the community) rather than future cash flows.
The main users of general purpose financial reports are investors, analysts, and regulators.	The main users of general purpose financial reports are Parliament and the public.

Note: For the purposes of this report, we have not attempted to explain the complex difference between exchange and non-exchange transactions.

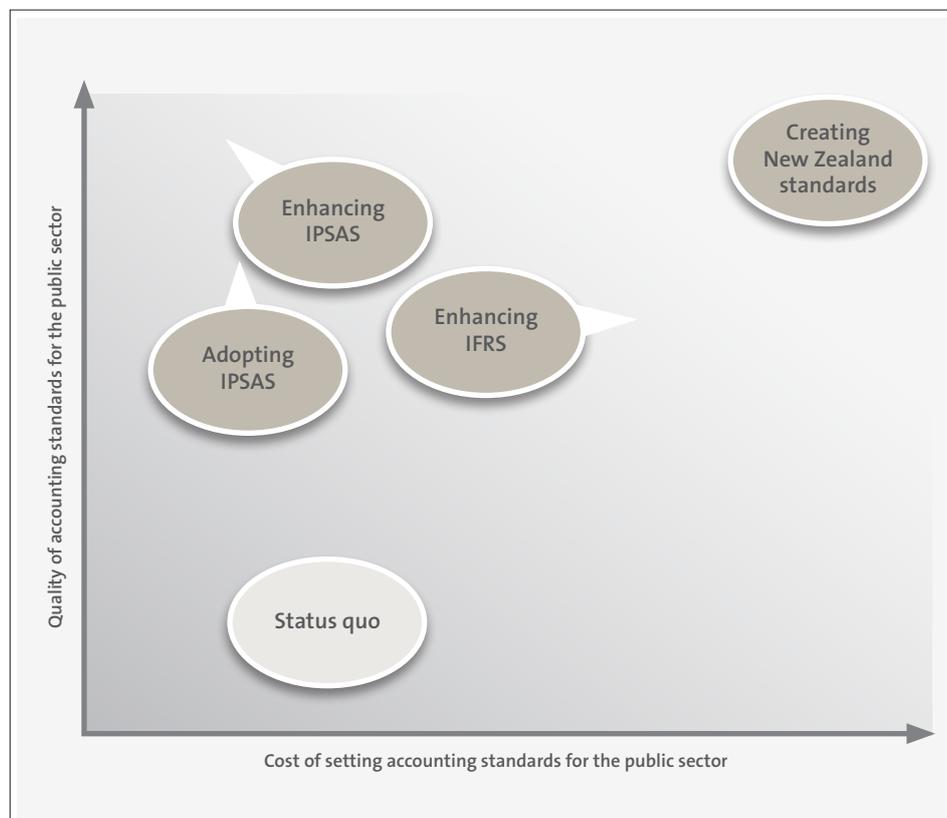
2.20 It was no surprise that accounting standards built on these principles were not well suited to public benefit entities.

### Advocating for a new approach

2.21 We advocated for relevant and appropriate accounting standards for all public entities that would result in reporting that could be used for decision-making and to properly hold public entities to account.

2.22 Our 2009 discussion paper outlined four broad approaches that could be used for future standard-setting. We explained the advantages and disadvantages of each approach. Figure 5 presents each of the four approaches based on the likely cost of setting accounting standards and the likely quality of the resulting standards.

**Figure 5**  
**Assessment of four approaches for setting accounting standards for the public sector**



- 2.23 **Enhancing IFRS** would have involved making changes to IFRS to make the accounting standards suitable for public benefit entities in the public sector. This would have required significant changes to NZ IFRS and would have come at a high cost. We had concerns about the effectiveness of this approach, given that the Accounting Standards Review Board approved minimal changes to IFRS to create NZ IFRS.
- 2.24 **Adopting IPSAS** would have involved making minimal changes to IPSAS and adopting them for public benefit entities. This approach could have resulted in accounting standards suitable for public benefit entities because IPSAS are designed specifically for such entities. This approach could have cost less than the other approaches because few changes would have been needed.
- 2.25 **Enhancing IPSAS** would have involved making appropriate changes to IPSAS for public benefit entities in New Zealand. This approach could have resulted in high-quality, fit-for-purpose accounting standards for the public sector. However, it was recognised that this would cost more than directly adopting IPSAS.
- 2.26 **Creating New Zealand standards** would have left the standard-setter free to draw on principles, ideas, and requirements from various sources, including IPSAS and IFRS. This approach could have resulted in high-quality public sector accounting standards but would have taken much longer and cost much more.
- 2.27 We presented the four options and explained the need for change in the hope that our views would be considered in shaping the future standard-setting arrangements in New Zealand.

## Significant changes since 2009

- 3.1 In this Part, we discuss the significant changes in accounting standards since we reported our concerns in 2009. Figure 6 summarises these changes.

**Figure 6**  
Timeline of significant changes to accounting standards in New Zealand since 2009



### External Reporting Board set up in July 2011

- 3.2 On 1 July 2011, the XRB was set up as an independent Crown entity, subject to the Crown Entities Act 2004 and section 22 of the Financial Reporting Act 1993 (now the Financial Reporting Act 2013). The XRB became responsible for setting accounting, auditing, and assurance standards.
- 3.3 The XRB Board comprises members appointed by the Governor-General on the recommendation of the Minister of Commerce. The XRB Board set up two sub-Boards:
1. the New Zealand Accounting Standards Board,<sup>5</sup> which is responsible for setting accounting standards; and
  2. the New Zealand Auditing and Assurance Standards Board, which is responsible for setting auditing and assurance standards.
- 3.4 Setting up the XRB ensured that a body independent of the accounting profession, and not subject to direction by the Government, prepared and set accounting standards. The changes also allowed the XRB to take full responsibility for financial reporting strategy and an active role in recommending changes to the existing accounting standards framework.
- 3.5 An early priority for the XRB was to review the effectiveness of the accounting standards framework. In its then form, the framework posed a significant obstacle to setting suitable accounting standards for much of the public sector.

<sup>5</sup> Our Office had a representative on the New Zealand Accounting Standards Board from 2011.

## Proposals for new Accounting Standards Framework agreed in April 2012

- 3.6 Since 2009, the Accounting Standards Review Board and, subsequently, the XRB have prepared a new Accounting Standards Framework.
- 3.7 In April 2012, the then Minister of Commerce approved the XRB's document, *Proposals for the New Zealand Accounting Standards Framework*. The XRB proposed, and the Minister agreed, that a multi-standards, tiered approach was needed to adequately meet user needs.
- 3.8 A multi-standards, tiered approach helps address two main issues:
1. Different types of entities operating in different environments are required to apply accounting standards.
  2. The size, significance, complexity, and resources of entities differ. For example, a smaller, less complex entity should be able to present simplified general purpose financial reports without compromising a user's ability to use the information for accountability and/or decision-making purposes.
- 3.9 The proposal was consistent with our view in late 2008. At that time, we were clear in our comments to the then Ministry of Economic Development<sup>6</sup> that financial reporting requirements for public entities should reflect the different types of entities in the public sector and their relative level of complexity.
- 3.10 The most significant proposal for the new legislative framework (see paragraphs 3.19-3.24) was to remove most small and medium-sized for-profit entities from the legislative requirement to report in keeping with generally accepted accounting practice. This has significantly reduced the number of reporting entities in the private sector in New Zealand.
- 3.11 When preparing the Accounting Standards Framework, the XRB considered that it was most useful to distinguish between for-profit and public benefit entities, to adequately reflect the different users and the information they need. The XRB split public benefit entities into **public sector public benefit entities** and **not-for-profit public benefit entities** because users of financial reports from these two groups need different information.
- 3.12 The new Accounting Standards Framework is a four-tier structure. Different accounting standards apply to each tier. Figure 7 summarises this tiered framework.

6 The Ministry of Economic Development later combined with other agencies to become the Ministry of Business, Innovation and Employment.

**Figure 7**  
**Features of the new Accounting Standards Framework**

	For-profit entities		Public benefit entities	
	Entities	Accounting standards used by these entities for general purpose financial reporting	Entities	Accounting standards used by these entities for general purpose financial reporting
Tier 1	Have public accountability or are large for-profit public entities (annual expenditure greater than \$30 million).	NZ IFRS. This is a full suite of for-profit entity accounting standards based on IFRS, with limited modifications for New Zealand's circumstances.	Have public accountability or are large entities (annual expenditure greater than \$30 million).	PBE accounting standards.  This is a full suite of public benefit entity accounting standards largely based on IPSAS, modified for New Zealand's circumstances.
Tier 2	Do not have public accountability and are not large for-profit public entities (annual expenditure less than \$30 million).	NZ IFRS with fewer disclosures.	Do not have public accountability and are not large entities (annual expenditure less than \$30 million but greater than \$2 million).	PBE accounting standards with fewer disclosures.
Tier 3	-	-	Do not have public accountability, have annual expenditure less than \$2 million, and not in Tier 4.	A simple format reporting standard, on an accrual basis.
Tier 4	-	-	Small entities that are permitted by legislation to use cash accounting and have annual operating expenditure less than \$125,000.	A simple format reporting standard, on a cash basis.

## Reporting under the new accounting standards from July 2014

- 3.13 The new accounting standards introduced for public benefit entities are called PBE accounting standards. For larger entities (Tiers 1 and 2), these standards are primarily based on International Public Sector Accounting Standards (IPSAS) modified for New Zealand circumstances. If there is no relevant IPSAS, the standards are usually based on IFRS or Financial Reporting Standards developed in New Zealand.
- 3.14 Although the size of an entity is usually important when determining which tier it fits into, smaller entities that have public accountability are required to report under Tier 1. The term “public accountability” has a technical definition in accounting standards that is narrower than the general meaning of public accountability.<sup>7</sup>
- 3.15 The PBE accounting standards became mandatory for public sector public benefit entities preparing general purpose financial reports with reporting periods beginning on or after 1 July 2014.

## Different accounting standards for public benefit entity reporting in Australia

- 3.16 When preparing the new Accounting Standards Framework, the XRB considered alignment with international accounting standards. This included Australian accounting standards, given the Government’s goals for harmonising trans-Tasman for-profit accounting standards to help build a more competitive and productive economy.
- 3.17 Australia does not currently have plans to move from a single set of standards based on IFRS. Therefore, our adopting a multi-standards, tiered approach increases the difference in public benefit entity reporting requirements between the two countries. However, the XRB considered that the benefits of an Accounting Standards Framework that better meets the needs of users in New Zealand outweighed the benefits of harmonising accounting standards for public benefit entities with Australia.
- 3.18 When the new Accounting Standards Framework was adopted, there was a high degree of alignment between IFRS and IPSAS. However, it is expected that the two suites of standards will diverge. This will widen the gap between accounting standards for public benefit entities in Australia and New Zealand.

<sup>7</sup> The definition of public accountability is included in the XRB A1 *Application of the Accounting Standards Framework*, which is available on the XRB’s website. The definition includes entities that issue debt or equity to the public.

## New State sector and public finance legislation

- 3.19 The State Sector and Public Finance Reform Bill 2013 amended the three main Acts that govern the management of the State sector and the finances of public entities. These Acts are the State Sector Act 1988, the Public Finance Act 1989, and the Crown Entities Act 2004.
- 3.20 The objectives of these reforms were to:
- help the system function more effectively and efficiently by enabling government departments to work better together, and creating flexibility through mechanisms such as multi-category appropriations;
  - encourage improved service levels and value for money through whole-of-government directions and the creation of the departmental agency organisational model;
  - support meaningful reporting so that Parliament and the public can more easily see what has been achieved; and
  - strengthen leadership at the system, sector, and agency level.
- 3.21 There have also been changes to the Financial Reporting Act 1993 and the Companies Act 1993. In 2013, the Financial Reporting Act 1993 was replaced by the Financial Reporting Act 2013. The reporting requirements for companies are now set out in the Companies Act 1993.
- 3.22 The legislative changes broadly aimed to:
- provide for the development of strategies for a reporting framework, including a strategy for tiers of financial reporting;
  - reduce compliance costs by removing any requirement for small or medium-sized companies in the private sector to prepare general purpose financial reports;
  - streamline reporting by companies and their subsidiaries by requiring reporting at the group level (instead of at the parent and group level) and reducing the number of subsidiaries that have to prepare separate general purpose financial reports;
  - improve reporting by charities; and
  - standardise the technical detail and wording of reporting requirements in legislation.

3.23 Securities' legislation has also been reformed. The Financial Markets Conduct Act 2013 aims to:

- promote the confidence and informed participation of business, investors, and consumers in the financial markets; and
- promote and facilitate the development of fair, efficient, and transparent financial markets.

3.24 Previously, the conduct of financial markets was primarily under the Securities Act 1978, supplemented by the Securities Markets Act 1988, the Securities Transfer Act 1991, the Superannuation Schemes Act 1989, the Unit Trusts Act 1960, and parts of the KiwiSaver Act 2006. The Financial Markets Conduct Act 2013 and other financial markets legislation replace those Acts.

# Have the changes resolved our concerns?

- 4.1 In this Part, we discuss the effect of changes since 2009 and whether the changes have resolved our concerns.
- 4.2 As noted in Part 2, we had two general concerns about adapting IFRS for the public sector. We were concerned about the complexity of the requirements, particularly for smaller entities, and the difficulty in applying many of the requirements in NZ IFRS to public benefit entities.

## Overall, changes are encouraging

- 4.3 We are encouraged by the changes to accounting standards since we reported our concerns in 2009.
- 4.4 In our view, setting up the XRB as an independent standard-setter has had a positive effect on accounting standards for the public sector. We acknowledge the significant work carried out by the then Ministry of Economic Development and the XRB. Although there is still work to be done, we consider that public entities are now better positioned to report information that is useful for accountability and decision-making purposes.
- 4.5 The separation of accounting standards applying to for-profit entities and those applying to public benefit entities is sensible. This is because the principles in the PBE accounting standards are inherently more suitable for public benefit entities. The standards use language appropriate for the public sector, and guidance focuses on transactions common to public benefit entities.
- 4.6 Also, the tiered structure of the new Accounting Standards Framework is likely to help smaller entities achieve a better balance between the costs and benefits of general purpose financial reporting.

## Positive changes in the new Accounting Standards Framework

- 4.7 Overall, the change to the new Accounting Standards Framework has been positive and augers well for the future of financial reporting in the public sector. The new Framework addresses our previous concerns by applying a multi-standards, tiered approach. By drawing on IPSAS, IFRS, and (where appropriate) Financial Reporting Standards developed in New Zealand, the XRB has put in place a comprehensive suite of PBE accounting standards, appropriate to the size and type of entity.
- 4.8 Previously, there were essentially only two tiers of reporting. Larger entities reported under the full suite of accounting standards. Smaller entities (that met certain criteria) reported under Differential Reporting Accounting Standards, which had fewer requirements.

## Part 4

### Have the changes resolved our concerns?

- 4.9 The new Accounting Standards Framework has four tiers for public benefit entities, which are designed to reduce the complexity of reporting for smaller entities.
- 4.10 The reporting concessions that apply to Tier 2 reporting entities generally mean they need to make fewer disclosures than Tier 1 reporting entities. However, entities moving from the previous NZ IFRS Differential Reporting Accounting Standards will notice some additional reporting requirements, such as the requirement for a cash flow statement. This requirement will involve more work for entities and their auditors, but a cash flow statement is expected to provide useful information to users.
- 4.11 For Tier 3 reporting entities, the XRB has prepared a simple format reporting standard that is based on accrual accounting. The standard is about 60 pages, and optional reporting templates are supplied. The standard for these smaller entities is concise compared to the many accounting standards for larger entities. Again, the reporting requirements include a cash flow statement.
- 4.12 We are pleased to see that reporting requirements for smaller public benefit entities have been simplified by adding Tier 3 simple format reporting.
- 4.13 For Tier 4, the XRB has put aside many of the complexities associated with accrual accounting. It has produced a largely cash-based accounting standard for the smallest public benefit entities, which can be applied if their legislation allows them to use a cash-based standard. The Tier 4 standard is about 30 pages.
- 4.14 A Tier 4 reporting entity is likely to have fewer resources than a larger entity. An example of such an entity is a cemetery trustee. Volunteers with little or no knowledge of accounting will often perform the accounting function. To help these people and to make it easier for the very smallest entities to apply the standard, the XRB has prepared reporting templates to be used as a guide.
- 4.15 Although we are pleased that Tier 4 reporting entities can use the simplified cash reporting standard, we acknowledge that the standard might require some entities to disclose more information than they have in the past.
- 4.16 We encourage all public entities to take full advantage of any financial reporting concessions that are available in the tiered structure.

## Good platform for future financial reporting

- 4.17 The new PBE accounting standards provide a good platform for future financial reporting by public benefit entities in the public sector.
- 4.18 The PBE accounting standards have resulted in numerous disclosure changes at a detailed level. However, overall, the required disclosures for larger entities remain similar to before.
- 4.19 We are pleased to see that recent changes to the accounting standard dealing with the presentation of financial statements have reinforced the need for preparers to consider the materiality of disclosures rather than disclose everything referred to by accounting standards. The standard allows preparers to “reduce the clutter” in financial statements by not reporting information that preparers consider not material for readers.
- 4.20 We would like to see public entities take more advantage of the flexibility available within the new PBE accounting standards to prepare general purpose financial reports that are more useful. There is scope to reduce the complexity of reporting by focusing on the information that is material to users.

# 5

## Challenges arising from the new accounting standards

- 5.1 Although the change to a new Accounting Standards Framework has been positive, there are still challenges when applying PBE accounting standards to public benefit entities.
- 5.2 In this Part, we discuss our concerns about some of the more substantive changes in the new accounting standards, and specific issues that we have seen during implementation.

### **Our concerns about some of the substantive changes**

- 5.3 Many public entities have now reported for the first time using the new accounting standards. We are evaluating the effect of the changes and will continue to do so as all public entities apply the new accounting standards.
- 5.4 Overall, the transition to the new PBE accounting standards represents a positive step, although there have been some issues with implementation.

### **Limited guidance for classifying revenue transactions**

- 5.5 The PBE accounting standards introduced a new standard for non-exchange transactions. These transactions, such as tax revenue, commonly occur in the public sector where funding moves but no direct goods or services are received in exchange. Previously, NZ IFRS included a standard on exchange transactions, such as the sale of goods and services, that more commonly occur in the private sector. There was no standard for non-exchange transactions.
- 5.6 Although it is helpful to have separate accounting standards for exchange and non-exchange transactions, there is limited guidance about how to distinguish between the two. This means that entities and their auditors are spending much time and effort trying to distinguish between types of revenue when preparing general purpose financial reports.
- 5.7 This issue has been most visible where revenue is received for services spanning reporting years. Distinguishing between the two types of revenue could affect whether revenue is recognised in one or more of the reporting years.
- 5.8 The XRB is aware of our concerns about classifying revenue in public sector general purpose financial reports. The International Public Sector Accounting Standards Board is currently carrying out a project on revenue designed to produce further guidance on how public sector public benefit entities should account for revenue. XRB staff will help the International Public Sector Accounting Standards Board throughout this project.

### **Conflicting requirements for service concession arrangements**

- 5.9 In the public sector, a service concession arrangement is where a public entity (the grantor) contracts with another party (the operator) to provide a service on their behalf. The operator often makes use of some of the assets of the grantor to deliver the contracted services. Sometimes, the operator is responsible for constructing the asset. The service will usually be provided for an agreed period and at a negotiated price. For example, a public entity might contract with a private sector entity to operate a prison or a hospital.
- 5.10 NZ IFRS did not include a standard on accounting for service concession arrangements by the grantor. The introduction of this standard within the PBE accounting standards has provided guidance to improve accounting by public benefit entities in this area.
- 5.11 However, there are conflicting requirements between the new standard and another standard within the PBE accounting standards. The conflicting requirements make it difficult for public benefit entities to comply with both standards.
- 5.12 We and the Treasury have written to the International Public Sector Accounting Standards Board highlighting this issue and suggesting some options to improve reporting. The Board has proposed making changes to address the inconsistency, and we expect the changes to be made to the accounting standards during 2016.

### **Less transparency about related party disclosures**

- 5.13 A related party transaction is a transaction where those involved have – or appear to have – a close relationship. There is a risk that those parties might make an agreement on terms that are more favourable than would occur in an arm’s-length transaction. The accounting standard for Tier 1 and Tier 2 public benefit entities about related parties provides guidance about how to disclose those relationships to the users of general purpose financial reports.
- 5.14 NZ IFRS included a standard on accounting for related party transactions. The new standard within the PBE accounting standards no longer requires disclosures of related party transactions that take place on normal terms and conditions.
- 5.15 Auditing of related party disclosures has become more challenging, particularly when assessing whether related party transactions are on “normal terms” and how those judgements are made and supported.
- 5.16 Overall, we expect the new standard will mean fewer disclosures of – and less transparency about – related party transactions by public benefit entities in the public sector. As a result, there is a risk that the new disclosure requirements will affect the transparency of general purpose financial reports in the public sector.

## Other implementation issues

### Performance information requirements and guidance could be better

- 5.17 Many public entities are required to report on their performance. Performance information covers service delivery and achievements. It is an important part of the accountability documents prepared by many entities in the public sector. Performance information needs to be combined with financial information to convey a coherent and complete picture about the public entity's performance.
- 5.18 In our view, the requirements and guidance about performance information that is included in generally accepted accounting practice needs to be updated and improved to ensure that performance information meets the needs of users for accountability and decision-making purposes.
- 5.19 The XRB is working on a standard about reporting performance information that will become part of generally accepted accounting practice. An "exposure draft" of this standard has recently been released for public comment. In our view, it is important for this standard to be flexible enough for performance reporting in the public sector to continue to evolve.

### Guidance for determining whether an entity controls another entity is not easy to apply

- 5.20 Guidance for determining whether an entity controls another entity is important. It affects not only when it is appropriate for an entity to prepare consolidated financial statements but also which entities are public entities. If an entity is not classified as a public entity, the Auditor-General is not its auditor. This matter can be particularly challenging when the entities are charitable trusts or limited partnerships.
- 5.21 NZ IFRS contained guidance for determining whether an entity controls another entity. The PBE accounting standards also have a standard for assessing control. However, neither of these standards have been easy to apply. This has sometimes resulted in a lack of clarity.
- 5.22 We are pleased to see that the XRB is working on a new PBE accounting standard to update guidance on this matter.

### Conceptual framework is needed

- 5.23 We consider it important to have a conceptual framework to help public benefit entities interpret requirements in the accounting standards. Such a framework is particularly useful where there is no directly applicable accounting standard. It is also important for helping standard-setters to create new accounting standards.
- 5.24 We are pleased to note that the XRB is preparing a conceptual framework for public benefit entities, based on the International Public Sector Accounting Standards Board's conceptual framework.

# Where next for financial reporting in the public sector?

- 6.1 In this Part, we discuss the challenges that continue to face standard-setters, preparers, and auditors to keep general purpose financial reporting relevant and useful.

## Continuing to focus on user needs

- 6.2 In 2015, public entities reported for the first time under the new Accounting Standards Framework. We discussed in Part 4 how the new Framework has reduced the complexity of reporting requirements. We hope that less complex requirements will help users to better understand the performance of these entities.
- 6.3 We expect the new PBE accounting standard on service performance reporting, due to be issued by the XRB in 2016, to further improve the reporting of performance information. We expect performance information to be better integrated within the general purpose financial reports.
- 6.4 It is important that the XRB continues to improve the Accounting Standards Framework in line with the information needs of users. There will always need to be a balance between ensuring that the Framework is not overly complex and recognising that entities are operating in increasingly sophisticated environments.
- 6.5 The needs of the range of users of general purpose financial reports are also changing. Each user's need for information is different, and what an individual requires today might be different to what they require next week or next year.
- 6.6 Public entities are increasingly focused on telling users a full performance story that is about more than just dollars and cents. This has led to increased use of infographics, case studies, and other material in annual reports to better illustrate or explain entities' results and outcomes.
- 6.7 Responses by preparers to the ever-changing needs of users show how financial reporting can provide a range of simple and detailed information. Simplifying important financial information – for example, total assets or net surplus – and presenting it graphically makes it easier to view on mobile devices or catch attention on social media.
- 6.8 However, users should also be able to access detailed information if they want it. This is possible when, for example, entities provide a summarised annual report with detailed supporting documents available separately.
- 6.9 In our view, it is important that entities do not allow the demand for simple formats to result in removing information that should be available to users. Sometimes, an entity should provide detailed information on particular issues, regardless of whether the issues are complex or unexpected.

- 6.10 Generally accepted accounting practice supports a reporting approach that focuses on the materiality of disclosures in general purpose financial reports. We hope that public entities will focus more on providing useful information and less on complying with matters that might not be material or useful to users of the reports.
- 6.11 By their very nature, most general purpose financial reports look back at the performance of an entity, often providing comparisons with what was planned or budgeted. This is a challenging concept in a fast-paced world, where real-time information is in demand. If users continue to ask for faster reporting, the challenges will include being able to respond to disruptive changes to reporting cycles, and the way information is prepared, without affecting quality.

### **Helping users understand the inherent uncertainties**

- 6.12 General purpose financial reports typically include the effect of estimates and judgements made by the entity. These can be as simple as predicting how much revenue earned during the year will not be collected because of customer defaults or as complex as valuing a derivative financial instrument. Often, the biggest numbers in the financial reports are based on estimates and judgements by those who govern the entity.
- 6.13 We expect such estimates and judgements to be made. However, the inherent uncertainties associated with these matters must be effectively communicated to users through general purpose financial reports so users can appreciate the potential variability in reported amounts.
- 6.14 To increase the visibility of such estimates and judgements in general purpose financial reports, a “key audit matters” section will soon be added to the audit reports of some New Zealand entities, including listed issuers. Entities (with a higher level of public accountability) reporting under the Financial Markets Conduct Act 2013 will also be included.
- 6.15 In the next few years, we expect to add a “key audit matters” section to a small number of our audit reports, including the University of Canterbury, Genesis Energy Limited, Air New Zealand Limited, and the Financial Statements of the Government.

### **Focusing on what matters most**

- 6.16 There is an increasing focus on “reducing the clutter” in general purpose financial reports. For example, there is updated guidance in generally accepted accounting practice for preparers about the use of materiality and guidance by professional bodies such as the 2015 report by the Chartered Accountants Australia and New Zealand, *Noise, Numbers and Cut-Through*.

- 6.17 The new Accounting Standards Framework should help to “reduce clutter” to some extent, with PBE accounting standards tailored to the different types of entities and the transactions they carry out.
- 6.18 However, a further opportunity exists for all entities, including for-profit entities, to prepare general purpose financial reports that contain information that matters most to users. Preparers should look for opportunities to present information in a concise and accessible format, while including all relevant information.
- 6.19 Another positive initiative is the International Integrated Reporting Council’s integrated reporting framework. This helps preparers to tell their performance story, with a focus on what matters most for the individual entity. An integrated report aims to provide insight about the use of resources (such as funding and human resources), the external environment affecting the entity, and how key relationships with stakeholders are maintained.
- 6.20 This is a broader story than general purpose financial reports currently provide. It aims to provide users with more information about the value and long-term sustainability of the entity. We expect the concept of integrated reporting or a similar concept to continue to grow in popularity.
- 6.21 Legislative reforms were aimed at increasing service levels and value-for-money for public services. The reforms included giving chief executives greater powers of delegation to enable partnering with agencies outside the public sector.
- 6.22 To help reflect a more flexible and fluid system, the legislative reforms also introduced more flexibility to the reporting of operational performance. This included allowing more flexibility in the elements of performance that are reported, depending on the nature of the entity. We support more flexibility in reporting about performance.

### **Reducing the number of reporting entities**

- 6.23 Recent legislative changes have resulted in certain smaller entities no longer being required to separately report financial information. Instead, this information will now be reported only within the group.
- 6.24 Although this is a step in the right direction, by better balancing the costs and benefits of public reporting, we would like to see a continued focus on whether the “right” public entities are reporting. Further legislative change could be needed to ensure that only such entities are required to prepare general purpose financial reports.

- 6.25 As corporate structures continue to evolve, financial reporting might be required by “activity-based” units, rather than the traditional entity-based reporting.

### **Keeping pace with technology**

- 6.26 As technology evolves, and public entities move towards reporting against wider objectives, there is likely to be an increasing focus on the capability of those tasked with preparing general purpose financial reports.
- 6.27 It is difficult to predict the future information needs of users, but preparers must continue to embrace change to provide what is required. This could include gaining increased expertise in technology and data analysis.
- 6.28 Summarised information can be useful because it is quicker to read and users are less likely to get bogged down and miss the main messages. However, there is a tension between giving readers high-level messages and providing enough detail to maintain accountability and transparency.
- 6.29 Negotiating these challenges will be important. However, most of all, the principles of the accounting and auditing professions – such as integrity, objectivity, transparency, governance, and accountability – need to continue to underpin general purpose financial reporting.

# Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

- Defence Force personnel involvement with a commercial entity – Miltech
- Principles for effectively co-governing natural resources
- Governance and accountability for three Christchurch rebuild projects
- Central government: Results of the 2014/15 audits
- Delivering scheduled services to patients – Progress in responding to the Auditor-General's recommendation
- Matters arising from the 2015-25 local authority long-term plans
- Earthquake Commission: Managing the Canterbury Home Repair Programme – follow-up audit
- Ministry for Primary Industries: Preparing for and responding to biosecurity incursions – follow-up audit
- Governance and accountability of council-controlled organisations
- Queenstown Lakes District Council: Managing a conflict of interest in a proposed special housing area
- Reviewing aspects of the Auckland Manukau Eastern Transport Initiative
- Annual Report 2014/15
- Inquiry into Health Benefits Limited
- Service performance reporting: Results of the annual audits of TEIs for the year ended 31 December 2014
- Request for inquiry into the regulation of the ancient swamp kauri industry

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