

Minimum financial reporting requirements for companies

An officials' issues paper on possible changes to the preparation of financial statements

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CHAPTER 1

Introduction

- 1.1 The Financial Reporting Act 1993 is currently being rewritten so that most companies will no longer be required to prepare general-purpose financial statements. This paper discusses the consequences of this development from a taxation perspective.
- 1.2 Cabinet has agreed, as part of a much wider range of financial reporting reforms, that all active companies should continue to prepare financial statements. While most of these companies will soon have no obligation to prepare general-purpose financial statements, they will still be required to prepare financial statements at least to a special-purpose level.
- 1.3 Inland Revenue, as the biggest user of financial statements in New Zealand, will administer the setting of minimum requirements for these financial statements. Proposals to amend the Tax Administration Act 1994 for this purpose are currently before Parliament.¹ This legislation will set up a framework to allow Orders in Council to mandate who should prepare financial statements and to what degree of detail.
- 1.4 These financial statements, which can be prepared to any level above the minimum specified by Inland Revenue, will obviously also be available for other purposes and users.
- 1.5 The discussion in this paper is not limited to companies, although the formal proposals will apply only to companies from years commencing 1 April 2014 onwards. This paper discusses which companies will be required to prepare financial statements and the minimum degree of detail that they will need to provide. Indicative thinking on how this might be extended to non-corporate business taxpayers is also discussed, but formal consultation on this is scheduled for next year.
- 1.6 Compliance implications are a major consideration. We do not anticipate any material increase in compliance costs for companies affected by these changes. Overall, because of the removal of the general-purpose reporting requirement as part of the wider company financial reporting reforms, it is anticipated that compliance costs will decrease. However, we accept that it is only medium-sized companies that are presently complying with the general-purpose rules which will potentially enjoy this decrease. Other companies that currently prepare financial statements should not be significantly affected.

¹ Clauses 110 and 111 of the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill.

- 1.7 Inland Revenue officials are participating in the New Zealand Institute of Chartered Accountants' SME Working Group which is recommending an accounting framework for special-purpose financial statements for small and medium enterprises (SMEs). It is too early to know exactly how this will integrate with Inland Revenue requirements, but it seems that compliance with that framework will mean Inland Revenue's minimum requirements are likely to be exceeded.

How to make a submission

- 1.8 Submissions are invited on:
- the proposal to exclude non-trading companies that are presently not required to file tax returns from the preparation requirement; and
 - the level of detail that is suggested for the financial statements.
- 1.9 The Minister of Revenue will be required under the proposed legislation to ensure that adequate consultation has taken place before he makes a recommendation that the Orders in Council be approved.

The proposals in summary

- Who would be affected:
 - For periods commencing 1 April 2014 and later, all active companies that do not have a statutory obligation to prepare general-purpose financial statements should prepare financial statements to at least a special-purpose level.
- Minimum suggested requirements:
 - They should be based on double entry cost-based accrual accounting.
 - They should include a balance sheet and profit and loss, and specified supporting notes and/or schedules should also be available.
 - Where reasonably possible, tax values can be used for the determination of income and expenditure, and the preparation of the balance sheet.
 - A statement of accounting policies and changes should be part of the financial statements.
 - They should include, if necessary, a financial statements to taxable income reconciliation.
 - Certain related-party transactions should be scheduled (but only for periods commencing 1 April 2015 and later).
 - While disclosure of the IR 10 key points is proposed, there is scope for judgement on the level of detail beyond this.

- 1.10 The phasing out of the Financial Reporting Act requirements for companies depends on the introduction of proposals suggested in this paper. This will be arranged so that it is seamless.
- 1.11 Inland Revenue indicatively suggests that non-corporate businesses should also be required to prepare special-purpose financial statements, perhaps for periods commencing 1 April 2015 and later. However, this is not part of the formal proposals in this paper, but rather, an indication of our current thinking. Comments on this are welcome, but formal consultation will take place next year.
- 1.12 Submissions on this paper should be made by 20 December 2013 and can be addressed to:

Financial reporting
C/- Deputy Commissioner
Policy and Strategy Division
Inland Revenue Department
P O Box 2198
Wellington 6140

Or email: policy.webmaster@ird.govt.nz with “Financial reporting” in the subject line.

- 1.13 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

The Financial Reporting Bill and its consequences

- 2.1 The Financial Reporting Bill, currently before Parliament, proposes to reform the requirements of companies to prepare financial statements. This is part of a wider range of reforms that include the removal of the Financial Reporting Act 1993 requirements for companies other than large companies or companies that are issuers to prepare general-purpose financial statements.
- 2.2 However, this does not mean these companies will no longer have to prepare financial statements. Cabinet has agreed, as part of the process that led to the Financial Reporting Act rewrite, that it is appropriate that companies that no longer have to prepare general-purpose financial statements should continue to prepare financial statements expressly designed to meet Inland Revenue's needs, but to a lower minimum level than general-purpose financial statements.
- 2.3 Further, Cabinet agreed that Inland Revenue should mandate this and should specify the minimum requirements for these financial statements, and that these statements could be special-purpose financial statements. While one obvious purpose of these financial statements would be to satisfy Inland Revenue requirements, they could also have other uses – both for management and owners, and for financiers and other creditors.

Inland Revenue's current position

- 2.4 Inland Revenue is New Zealand's biggest user of financial statements. Financial statements are the basis for taxpayers preparing the summary form – the IR 10 – of which 700,000 are filed each year by about 550,000 active businesses. This form is used for Inland Revenue purposes, but is also very important for Statistics New Zealand for business statistical purposes.
- 2.5 Inland Revenue regularly requests financial statements for compliance risk review, investigations and for debt collection. There are also occasions when financial statements of New Zealand taxpayers are requested by our tax treaty partners. Thus, for relevant taxpayers, it is reasonable for Inland Revenue to expect these taxpayers to prepare financial statements and to make them available upon request.
- 2.6 These requests will typically be under section 17 of the Tax Administration Act 1994. Subsection 17(1) presently allows Inland Revenue to request financial statements under its general powers. Subsection 17(2) currently contains an explicit requirement that companies must make available upon request: "*balance sheets, ... profit and loss accounts and other accounts, and statements of assets and liabilities*".

Tax Administration Act amendments

- 2.7 The new requirements could be set by way of Act of Parliament (legislation), Order in Council or Inland Revenue determination. A balancing act is required between ensuring that there is enough external review of the requirements before they are mandated, and ensuring that they can be amended in a reasonably flexible way. Orders in Council, which are approved by Cabinet, provide an appropriate balance.
- 2.8 Because requirements will be mandated by Order in Council there should also be sufficient flexibility to impose different requirements on different classes of taxpayer. An example would be the different requirements placed on individuals whose business income is schedular payments – refer below. Over time, the initial requirements can be refined and could lead to increased use of the flexibility that Orders in Council provide, following proper consultation.
- 2.9 The Tax Administration Act is being amended to create a framework for the Orders in Council under new sections 21C and 21D. This process explicitly includes a requirement for the Minister to be satisfied that consultation has taken place to ensure that private-sector views have been considered in the preparation of the requirements. As well, subsection 17(2) of the Tax Administration Act will be consequentially repealed.
- 2.10 These financial statements would not have to be held in hard copy, as long as they are prepared as part of the tax return process. Further, there would be no requirement to annually file these financial statements with Inland Revenue. Rather, as indicated above, they would form the basis from which the IR 10 is prepared and filed and they would be available to Inland Revenue upon request.
- 2.11 One of the eventual outcomes of this project is that the minimum reporting requirements will be consistent across similar types of taxpayers.
- 2.12 In suggesting that Inland Revenue mandate the minimum reporting requirements, it is not attempting to set itself up as an arbiter of accounting standards – this is not Inland Revenue’s role. Inland Revenue’s main interest is in the receipt of the correct amount of tax and compliance with its third-party obligations.

CHAPTER 3

Who should prepare financial statements and to what level

- 3.1 This chapter contains the specific proposals upon which submissions are sought. They are proposed to apply from years commencing on or after 1 April 2014 to active companies that will not then have a statutory obligation to prepare general-purpose financial statements. Chapter 4 discusses the detail that might apply to non-corporate businesses in the future.

To what level should the financial statements be prepared?

- 3.2 We suggest that the minimum requirements for these financial statements would be relatively straightforward historical cost, double-entry, accrual-based financial statements that would constitute special-purpose financial statements. Where appropriate (for example, for depreciation) the financial statements can be based on taxation-based amounts and concepts. Information to be disclosed would be sufficient to allow, where relevant, the preparation of the IR 10, and to allow a review of the entity's performance.
- 3.3 Notes to the financial statements or separate schedules would include a statement of accounting policies and detail of related-party transactions. Where accounting profit and taxable income are different, a reconciliation would also be required, but tax values could be used wherever appropriate in the financial statements – for example, for depreciable assets or for farmers' fencing expenditure.
- 3.4 Obviously the use of tax values in financial statements would not be appropriate where they did not follow the cash-based amounts. An example of this would include the ownership of a look-through company (LTC) where the cash could be dividends or loans, but the taxable values would be a proportion of the LTC's taxable income. Another example would be the difference between cash and taxable income from say a listed PIE. These should be adjusted for in the tax reconciliation. However, this discussion is only relevant where the relevant asset (for example, the LTC or the PIE) is included as part of the taxpayers' financial statements.
- 3.5 In reality, the minimum financial reporting requirements for companies would likely be only slightly more extensive than the present requirement of the Financial Reporting Order 1994, which presently applies to small companies.
- 3.6 Requirements would be principles-based, although some detail would be required. This is because it is inappropriate for Inland Revenue to attempt to set the format of financial statements or tell accountants the specific detail of what should be in financial statements. Rather, it is envisaged that Inland Revenue would set the principles and some of the detail and then rely on the judgement of the person preparing the financial statements. The proposed detail about the level of reporting and associated disclosures is contained in the Appendix.

- 3.7 Given the potential complexity of related parties' information that we are asking for (see the Appendix) we propose that this requirement apply for tax years commencing on or after 1 April 2015. As a result of our preliminary discussions with software providers, we do not anticipate that any other of the information would be technically difficult to provide.
- 3.8 For medium-sized companies that are complying with the present requirement to prepare general-purpose financial statements, compliance costs should decrease as these are replaced by special-purpose financial statements. This compliance cost-saving has been factored into the proposed replacement of the Financial Reporting Act discussed above.
- 3.9 Current Tax Administration Act requirements that all taxpayers should have sufficient records to support their tax returns will be continued.
- 3.10 Inland Revenue officials are participating in the New Zealand Institute of Chartered Accountants' SME Working Group which is developing a recommended accounting framework for special-purpose financial statements for SMEs. It has yet to be determined exactly how this framework will match with the minimum requirements that Inland Revenue is contemplating.
- 3.11 However, it seems very likely that if financial statements are prepared in accordance with the New Zealand Institute of Chartered Accountants' SME framework, they will exceed Inland Revenue's minimum requirements. The Inland Revenue requirements for financial statements would be minimum requirements – taxpayers would be free to include additional disclosures if they choose, and to comply with the framework, or even produce partially or fully GAAP-compliant² financial statements if they want to.

² Generally accepted accounting principles.

CHAPTER 4

Non-corporate business that could prepare financial statements

4.1 This consultation is concerned with the company position, which is more immediately important given the wider objective of removing the present general-purpose requirement from years commencing 1 April 2014 onwards. However, Inland Revenue has done some preliminary thinking about which non-corporate business could be required to prepare financial statements. While this thinking is nowhere near final, comments are invited on the following:

- From the tax year commencing 1 April 2015 or equivalent, subject to a minimum threshold, other taxpayers that are in business such as sole traders, partnerships and limited partnerships, and trusts could also be required to prepare special-purpose financial statements. Regardless of the attribution of partnership transactions to partners, the partners would not be required to also prepare financial statements in respect of their partnership interests (which also includes LTC and special partnership interests).
- The minimum threshold for these other businesses should be such that micro-businesses should have no financial reporting obligations. However, it would seem that views of what a micro-business is vary considerably. We suggest that the GST registration threshold (\$60,000 turnover or expenses, but ignoring sales or purchases of capital assets and other balance sheet transactions) is an obvious starting place. This would exclude about 40 percent of the 550,000 active IR 10 filers. However, we are very open to discussion on this.
- Comment is specifically invited on whether natural individuals who derive schedular payments could usefully be exempted from this preparation requirement if their expenses are small compared with their income – say, expenses of less than 10 percent of income.

4.2 Except at the margin, we believe that most of these taxpayers are presently preparing financial statements and so there should be minimal compliance costs involved. However, we acknowledge that this is dependant on the selection of an appropriate threshold. We recognise there will be varied private-sector views about this. We welcome feedback on this now, in advance of more formal consultation on the matter, which is scheduled for next year.

APPENDIX

Proposed minimum financial reporting requirements

These are the proposed minimum financial reporting requirements for special-purpose financial statements (SPFR) for companies that are in the tax base.

These minimum requirements are high-level and, while financial statements and accompanying schedules must be prepared to at least these minimum requirements, they may be prepared to a higher standard or even be general-purpose financial statements, so long as the required information is provided. If they are prepared to a higher standard that is recommended by a professional accounting body or by the External Reporting Board, items specifically footnoted on page 10 would not be explicitly required.

The minimum requirements proposed are:

- The financial statements should consist of a balance sheet and a profit and loss statement which shall be appropriately detailed.
- They should be based on double-entry historical cost-based financial statements prepared using accrual concepts.
- Where reasonably possible, tax values can be used for the determination of income and expenditure, fixed assets and depreciation, and the balance sheet.
- A statement of accounting policies and changes thereto that is sufficiently detailed that a user can understand the material policies that have been applied or changed in the preparation of the financial statements.
- Comparable figures for the last year should be disclosed.
- The financial statements or supporting schedules should show:
 - The relevant (for that taxpayer) IR 10 key points.
 - A fully detailed financial statement to taxable income reconciliation.
 - A reconciliation of tax losses and movements therein for the year including loss offsets and subventions, if any.
 - Related party transactions, except for:
 - casual sales and purchases, and other immaterial irregular non-remuneration transactions; and
 - transactions that are between New Zealand tax-resident companies that have a common balance date and are part of the same wholly owned group.
 - Notes should detail (qualifying companies are exempt from the first two requirements, look-through companies are exempt from all three of these requirements):
 - the available subscribed capital (shareholders' funds that can be returned tax-free to shareholders in qualifying circumstances) per class of shares issued;
 - any amount of realised capital gains that could be distributed tax-free upon the liquidation of the company; and
 - a reconciliation of opening to closing imputation credits.

- If a forester, a statement of cost of bush as at balance date and a reconciliation of movements.
- If a specified livestock owner, detail of livestock valuation methods, valuations and calculations for taxation purposes.
- A reconciliation of movements in shareholders' equity, and loans or current accounts to/from the owner and related parties.
- An appropriate note detailing "Exceptional items" – box 26 of the IR 10.
- An appropriately detailed taxation-based fixed asset and depreciation schedule.
- Interest should always be grossed up for resident withholding tax.
- Dividends should be grossed up for imputation credits to the extent that the dividend is taxable and the credits are usable to reduce the taxpayer's tax liability for that year.³
- All realised and unrealised gains and losses that are recorded in the financial statements should be recorded in the profit and loss.³

Exception

- When cash (and therefore book) and tax will never directly match (for example, portfolio investment entity and foreign investment fund income, entertainment expenditure) the financial statements should reflect the cash based position with the adjustment to the tax position being part of the book-to-tax reconciliation.

Explanation and comment (in no particular order):

- The financial statements can be GST-inclusive or GST-exclusive, so long as the end result is "net taxable income". However, where the taxpayer is registered for GST, GST-exclusive financial statements are strongly recommended.
- Taxpayers are welcome to use a higher financial reporting standard if they desire, or to disclose more information, so long as there is an appropriate reconciliation back to "net taxable income". For example, land and improvements may be included at valuation (and from Inland Revenue's perspective it does not matter who does the valuation, so long as the fact of revaluation is disclosed). Further, taxpayers may adopt specific financial reporting standards for part or all of their financial statements.
- "Appropriately detailed" has been deliberately left open for the judgement of the person preparing the financial statements. For example, the sales and trading stock purchases of a corner grocer are likely not to be broken down in lines, whereas, for a livestock farmer, sales and purchases of livestock will be detailed. However, in both cases a detailed listing of other expenditure will be expected. Where there is insufficient detail Inland Revenue has the power to ask for more detail. Further, the key points for the IR 10 should be part of the financial statements or the supporting schedules.

³ Not required if the financial statement has been prepared to a higher standard than recommended by a professional accounting body or the External Reporting Board.

- A fully detailed financial reporting profit to tax reconciliation is mandatory, except when there are no adjustments. For example, this will detail any movements in non-deductible provisions on a line-by-line basis and allow for the reversal of any non-taxable gains and/or losses.
- Related-party transactions except as specified, must be disclosed with appropriate supporting information – to/from, for, and the dollar amount. This should include remuneration, rents, dividends and interest. In this context, “related party” is as used in the IR 10 and its associated material.
- The requirement to take all realised and unrealised gains and losses to the profit and loss account, is to ensure that that the profit and loss statement is comprehensive and that these items are not be separately taken directly to shareholders’ equity.
- The IR 10 currently requires dividends to be recorded net of imputation credits. Consideration is being given to changing the IR 10 from the 2014–15 year to allow, in appropriate circumstances, dividends to be grossed up by any attached imputation credits.