Achieving quality financial reporting – guide for directors

Financial reporting is increasingly complex and many directors find it challenging to comply with the disclosure requirements of the standards while providing readers with information that is meaningful and understandable. As a result, boards are looking for innovative ways to communicate the most important messages to their stakeholders.

There continues to be significant focus internationally on the content and presentation of financial statements by the standard setters and regulators. In New Zealand, the Financial Markets Authority (FMA) has been engaging with financial statement preparers, users, auditors, and other stakeholders to support the move towards more effective disclosures. In its publication ‘Corporate Governance in New Zealand – Principles and Guidelines’ the FMA noted that “financial reporting and annual reports of all entities should, in addition to all information required by law, include sufficient, meaningful information to enable investors and stakeholders to be well informed. Financial statements are complex and can be challenging for readers. We encourage boards to aim for financial reports that are clear, concise and effective, while meeting the requirements of financial reporting standards.”

For directors to be successful in meeting their financial reporting obligations they need to drive the process, obtain the support of management, engage with their auditors and ask the right questions. This publication includes questions for directors to ask themselves and management regarding the annual reporting process. The questions cover the key aspects of financial reporting and are designed to assist directors in setting a new standard for high quality financial reporting.

Entities other than companies, may also find these considerations useful in preparing their annual report and/or financial statements.

“There is a clear need for disclosures contained within the financial statements to be refocused on their primary purpose. That is, to provide investors with useful information that will help them make decisions about providing resources to the business, and assess management’s stewardship of the resources entrusted to it.”


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The FMA’s Guidelines for Corporate Governance recommend that “*all boards should have a rigorous process for ensuring the quality and integrity of financial statements including their relevance, faithful representation, verifiability, comparability and timeliness*”. The achievement of such quality financial reporting requires the appointment of skilled staff, the implementation of appropriate processes and controls, and careful planning.

**Timetable**

- Has the board set aside time early in the financial year to focus on the year-end reporting process?
- Is there a timetable for the completion of year-end reporting? Is there adequate time for all issues to be properly addressed with flexibility to deal with unexpected events?
- Will the annual report and any market announcement content be provided to the board and the auditor with sufficient time to properly review them before concluding on the financial statements?

**Financial reporting process**

- Has the board sought legal advice, if required, to confirm its financial reporting obligations under the new legislation?
- Have the financial statements been prepared using the appropriate suite of standards? (e.g.: Tier 1, Tier 2 etc)
- Has the board considered materiality in the context of the current year financial statements and communicated this to management in order to assist decision making on what information should be disclosed in the financial statements?
- Should pro-forma financial statements be drafted so that the format, including new disclosures or omission of outdated disclosures can be considered in advance of year-end?
- Does management have a plan in place to address new guidance or findings raised by the Financial Markets Authority?
- Has the board assessed the use of the going concern assumption in the preparation of the financial statements? Are there any measures the board should take to address going concern issues (such as obtaining letters of support from a related party)?
- Will renewal of funding arrangements or waivers from covenant breaches be resolved by balance date? NZ IFRS requires the classification of debt as current or non-current to be based on the contractual obligations at balance date.
Engaging with the Auditors

☐ Is there a process to engage with the auditors throughout the reporting period to discuss materiality, significant transactions, and changes to accounting policies, including what impact these might have on the financial statements?

☐ Has the board considered whether the audit plan presented by the auditors addresses current risks?

☐ Have any matters raised by the auditors in the current and prior reporting periods been addressed?

☐ Has the board discussed with the auditor the matters they are considering for inclusion in the ‘Key Audit Matters’ section of the audit report under the new format? Has the board considered its own list of key matters and ensured these are properly described in the financial statements?

Resourcing

☐ Does the finance function need additional specialist skills, experience or resources to prepare the annual report and supporting information? If required, has a plan to increase resources been implemented?

☐ Does the board need to bring in specialist advisers to help it meet its responsibilities? If so, have specialists been engaged?

☐ Has the board considered whether the internal audit function (if applicable) should undertake any additional work in anticipation of the year-end, and if so, is it scheduled for completion so that the board has adequate time to consider the outputs prior to finalising the annual report?

☐ Has management conducted a recent review of the financial reporting environment to ensure that high-quality, well controlled and timely management data is available? Are any additional resources, controls or procedures required?

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2See Proposed International Standard on Auditing (New Zealand) 701 ‘Communicating Key Audit Matters in the Independent Auditor’s Report’, which is expected to apply for periods ending on or after 15 December 2016.
Communicate what matters

Financial reports should help users to understand the performance and position of the business. Instead of being a compliance tool, financial reports should tell the story of the entity’s current year financial performance, cash flows and financial position using narrative that is specific and relevant to the entity.

- Do the financial statements and annual report consider the information needs of investors and other key stakeholders?

- Has the materiality assessed at the planning stage been reconsidered in light of the actual results and financial position to confirm it is still appropriate?

- Are the financial statements logically structured and easy to navigate? Consider:
  - Are critical note disclosures prominently displayed?
  - Could content pages or cross referencing help users navigate to important information?
  - Are the disclosures clearly written using plain English?
  - Are the disclosures tailored to the entity’s circumstances? Has boilerplate wording been removed?

- Do the financial statements reflect the board’s knowledge of the company and its performance for the year and convey the appropriate messages? Is the narrative in the financial statements and annual report consistent with the financial information presented?

- Has bad news been properly disclosed and not obscured?

- Do the financial statements reflect the key decisions made by the board and key transactions during the year?

- Do the notes adequately explain the economic substance of transactions? Is additional information required for an understanding of the performance of the entity?

- Are risk disclosures and segment reporting consistent with internal reporting as required by NZ IFRS?

- Is there an appropriate process to ensure that all material disclosures are included and immaterial disclosures are removed? In particular, is there a document setting out why specific disclosures were excluded?
Ideas to Improve the Structure of Financial Statements to Highlight Important Information

- Include a table of contents
- Group relevant and important information together
- Display notes in order of importance
- Use boxes and shading to highlight key information
- Include significant accounting policies in the notes with the items to which they relate
- Use subheadings within notes to highlight topics of information
- Use plain English and remove boilerplate wording

Significant accounting policies

The board should consider whether the accounting policies adopted are appropriate to the circumstances of the company and whether alternative policies (where permitted by the relevant framework) would be more appropriate.

☐ Are the accounting policies clear, concise, complete and appropriate for the entity?
☐ Have the accounting policies been updated for changes to accounting standards? Are there new transactions or other events in the current year which need to be explained?
☐ Have policies which are immaterial or no longer applicable been removed?
☐ Do the accounting policies contain judgemental areas which should be highlighted (e.g.: timing of revenue recognition)?
☐ Has the impact of new accounting standards been considered in advance of when they will become applicable? Should the entity early adopt changes to standards? If not, have the standards not yet effective been disclosed with commentary on the likely impact for the entity if this could be material?
**Significant estimates and judgements**

The preparation of financial statements may require management to make estimates where the outcome of a particular matter is uncertain. Accounting estimates fall outside the scope of traditional internal accounting controls applied to systematically processed, recurring transactions and are therefore subject to increased risk of fraud or error. The board should carefully consider information on accounting estimates and satisfy themselves that the judgements made by management are reasonable.

☐ Has management provided the board with information on the significant accounting estimates based on judgement which have been made in preparing the financial statements?

☐ Is there evidence that judgements have been reached in an objective and neutral way? Have any alternatives been considered?

☐ Has the board considered any triggers that might motivate manipulation of the financial statements such as management bonus schemes, covenants etc? Are there adequate internal financial controls in place to protect against manipulation?

☐ Are any assumptions made by management consistent with the board’s understanding of the business, the industry and the entity’s business plan?

☐ Where the valuations of assets and liabilities are based on assumptions or models:
  - Have appropriate procedures and controls been applied to the entity’s use of models to generate cash flow and valuation information?
  - Are key assumptions applied consistently across all asset and liability valuations?
  - Has management adequately considered the sensitivity of estimates made?
  - Has the board considered whether key models need to be subject to independent analysis and verification, for example by internal audit or third party specialists?

☐ Do the financial statements prominently describe all the key judgements and major sources of estimation uncertainty, including sensitivities?
Significant or unusual transactions

The financial statements should prominently display information about significant or unusual events that have taken place during the year.

☐ What are the significant or unusual transactions and events that have taken place during the year? Are these items properly reflected in the financial statements? Have disclosures which are no longer relevant been removed?

☐ Has there been a process to identify all related parties of the entity, and the transactions, balances and commitments the entity has entered into with these parties? Are these transactions and their terms clearly disclosed?

☐ Have any share schemes for executives or other employees been properly explained and recorded in the financial statements?

☐ Has the company made any significant or unusual commitments?

☐ Has there been any impairment in the value of goodwill or any other intangible assets?

☐ Has the company entered into any new financing arrangements such as securitisations? Have these been disclosed in accordance with NZ GAAP?

☐ Have significant post balance date events up to the date of approval of the annual report and financial statements been disclosed?

Examples of significant or unusual items would include:

- asset acquisitions and disposals
- contingent liabilities such as litigation
- restructuring
- asset impairment
Materiality

If an entity is to ‘communicate what matters’ to its users, then the application of materiality is critical to ensure that relevant information is not omitted. Conversely, too much information might obscure the important information for users. Achieving the correct balance can be a challenge.

Materiality is an entity-specific consideration of what is relevant to the decision-making needs of its financial statement users and therefore there are no uniform thresholds for calculating materiality. As a result, professional judgement is required and consultation with the auditor is recommended.

Materiality is more than just a quantitative threshold over which items are disclosed. NZ IAS 1 notes that “omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor”.

As materiality references the size and nature of items (individually or collectively), then the qualitative nature of an item could be material even if the amount is small. For example, related party transactions on non-market terms may be material to users regardless of the amount.

For public benefit entities (PBEs), the New Zealand Accounting Standards Board has issued ‘Explanatory Guide A7: Materiality for Public Benefit Entities’ (EG A7).
Liquidity and going concern considerations

Difficult economic conditions and significant adverse events that affect an entity may require additional consideration and disclosure in the financial statements.

☐ Is the entity monitoring its position in relation to financial market volatility, and in particular its exposures to liquidity risk (whether the entity can pay its debts when they are due) and credit risk (whether counterparties will be able to make payment)?

☐ Has a cash flow forecast been prepared covering at least twelve months from balance date (and preferably at least twelve months from the expected date of approval of the financial statements)? Does this forecast indicate that there is sufficient liquidity taking into account existing funding arrangements? Should the cash flow forecast be extended beyond twelve months to evaluate issues that may arise subsequent to this period?

☐ Has an analysis been performed to ensure that the terms of current funding arrangements are being met? If covenants have been breached, have discussions taken place with the funder to secure waivers where possible? Have these arrangements, risks and any breaches been appropriately disclosed?

☐ If funding lines are due to expire within the year, will the entity be able to secure new funding or renew existing funding arrangements?

☐ Will the entity need to honour guarantees, indemnities or liquidity facilities provided to third parties? Does the entity have the resources to meet these obligations should they arise?

☐ Does the entity have sufficient access to funding should contingent liabilities eventuate?

☐ Is preparation of financial statements using the going concern assumption appropriate? If yes, are there any material uncertainties that need to be disclosed?
Many entities now report alternative profit measures such as ‘underlying profit’, ‘normalised earnings’ and ‘EBITDA’. The FMA issued a guidance note in September 2012 to assist entities in providing information to users that is meaningful and not misleading. The FMA guidance note, titled ‘Disclosing Non-GAAP Financial Information’, provides principles to follow when non-GAAP measures are used. A non-GAAP measure is defined as “financial information that is presented other than in accordance with all relevant GAAP”. The board should carefully consider why the alternative profit measures presented are useful and ensure that the financial statements include appropriate explanations of the measures so that readers are not misled.

- Is the non-GAAP measure an appropriate measure of the entity’s performance? Are the adjustments made in arriving at the non-GAAP measure consistent with other industry players? If not, why?
- Does the financial statement commentary about the entity’s performance clearly state which measure is being discussed and why?
- Should the board obtain assurance on underlying profit? If yes, from whom?
- Is a non-GAAP measure such as ‘underlying profit’ used to determine executive remuneration? Are the adjustments made to get from statutory profit to underlying profit appropriate?

Has the FMA’s guidance on disclosure for non-GAAP measures been applied:
- What is the purpose of reporting the non-GAAP measure selected, and has this purpose been explained in the annual report?
- Is there a reconciliation explaining the calculation of underlying profit and how it relates to the statutory profit, and has it been presented in a balanced manner?
- Is the label used appropriate?
- Is the approach to reporting adjustments transparent and comparable between reporting periods? Have comparatives been included?
- Is statutory profit disclosed more prominently than the underlying profit?
- Is there disclosure as to whether the non-GAAP measure has been audited or reviewed? (when disclosed outside the financial statements)

Where is the appropriate placement for this information?

As underlying profit often shows how the board and management view the business, should it be (and is it) consistent with the segment note in the financial statements (which is based on internal reporting)?
A Director’s Report or management discussion and analysis is not specifically required by the Companies Act 1993, although the Act does require details of material changes in the nature of the business of the company or class of business in which the company has an interest (section 211(1) a). Listed entities (NZSX/NZDX or NZAX/NXT) are required to provide commentary on the results for the period in a preliminary announcement in respect of a full year. To meet these requirements, or to provide context for investors on the entity’s financial results, many entities include a Chairman’s Report and a CEO’s Report in their annual report which provide an overview of the performance of the entity and any significant events that have occurred during the period.

- Is there a process to capture and disclose all the information required by legislation or regulation in the annual report? For example, as set out in the Companies Act 1993, Financial Markets Conduct Act 2013, NZX Listing Rules, and the FMA’s ‘Corporate Governance in New Zealand – Principles and Guidelines’.

- Are disclosures in the annual report consistent with the financial statements? For example, is the business discussed in the same way as any segment reporting?

- While not mandatory, has the IFRS Practice Statement ‘Management Commentary - A Framework for Presentation’ been considered? This guidance suggests that management commentary should include information essential to an understanding of:
  - the nature of the business,
  - management’s objectives and strategies for meeting those objectives,
  - the entity’s most significant resources, risks and relationships,
  - the results of operations and prospects, and
  - the critical performance measures and indicators that management uses to evaluate the entity’s performance against stated objectives.

- Will the annual report include any information about future prospects? Has the board considered whether these comments are reasonable and supportable? Does this commentary alert the user to the degree of uncertainty attached to these prospects and to the fact that actual results may differ?
Related information presented in addition to the financial statements might include summary financial statements, release of market announcements under the continuous disclosure rules, significant financial returns to regulators and transaction documents such as product disclosure statements.

- Are disclosures in financial statements and other related information consistent?
- Do the financial statements reflect all the relevant information previously released in other announcements?
- Where summary financial statements are to be published, have the requirements of FRS 43: Summary Financial Statements been followed? For audit efficiency, are these scheduled to be completed at the same time as the full financial statements?
- Has the board considered whether there is a need for additional disclosures about company circumstances under the continuous disclosure requirements? For example, early disclosure may need to be considered when directors first conclude that significant doubts exist about going concern, or issues arise regarding compliance with debt covenants.
- Does the board regularly consider whether information, if known to the investor, would impact the investor’s decision to purchase, sell or hold shares? Should this information be disclosed?
- If preliminary financial information is to be released, is it clearly marked as ‘unaudited’ where an audit opinion has not yet been issued on the financial statements?
- Where financial information is included in public announcements are the figures or measures presented consistently with the way they are discussed in the full financial statements (e.g. labelling and measurement) or with the way they will be reported in the next financial statements?
- Are any non-GAAP profit measures included in market announcements properly reconciled and not presented more prominently than the GAAP measures?
- Has the board satisfied itself that there is a process to ensure that all regulatory returns are being prepared, approved and filed appropriately? Has the board received a schedule of all regulatory returns required to be filed during the course of the year together with a clear description of the purpose and content of each?
- Has the board confirmed that any required register audits are completed on a timely basis?
- Has the entity reported on its performance against each of the corporate governance principles outlined in the FMA’s handbook ‘Corporate Governance in New Zealand – Principles and Guidelines’?
- Has the board considered the potential benefits of integrated reporting?
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