A Submission on the Financial Accounting Standards Board
Invitation to Comment:

Selected Issues Relating to Assets and Liabilities with Uncertainties

30 September 2005

The Sustainability Special Interest Group, is a special interest group of volunteers attached to the New Zealand Institute of Chartered Accountants.

The views expressed in this document represent views of the Sustainability Special Interest Group. They are not necessarily the views of the New Zealand Institute of Chartered Accountants.

December 2005
Introduction

This submission is prepared by members of the Sustainability Special Interest Group (SSIG) in response to the Financial Accounting Standards Board’s (FASB) Invitation to Comment: Selected Issues Relating to Assets and Liabilities with Uncertainties - 30 September 2005.

The SSIG became aware of the Invitation mid-December – immediately prior to the summer holiday season and this has produced challenges in the SSIG discussing the issues and reaching consensus over detailed issues.

In this context the SSIG, and with a concern the pros and cons of the proposals having not being fully examined in the ‘Invitation to Comment’, this submission concentrates on the underlying issues rather than attempting to answer the specific questions posed.

Purpose of the FASB

The mission of the FASB is;

To establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. (www.fasb.org)

The purpose is;

Serving the investing public through transparent information resulting from high-quality-financial reporting standards, developed in an independent private-sector, open due process. (www.fasb.org)

Purpose of the SSIG and this Submission

The vision of the SSIG is;

To enhance the understanding and implementation of sustainability in New Zealand businesses and organisations.

The purposes of the SSIG are to;

• Educate, encourage and inspire Institute members to promote and action sustainability concepts
• Encourage the Institute to take a leadership role in the development of guidance, frameworks and standards for reporting and verification
• Encourage and inspire the Institute to adopt and implement a sustainability culture and sustainable development reporting for its own operations
• Encourage and support members to implement sustainable development reporting in their organisations
• Encourage and support the Institute and New Zealand education providers to embed sustainability teaching and sustainable development reporting in their curricula.
The purpose in making this submission is to ensure the reporting of economic, social and environmental information is developed in a robust, relevant, cost-effective and comprehensive principles-based framework that meets a wide range of stakeholders needs. The SSIG is of the view quality reporting must not only be accurate, comprehensive, relevant, cost-effective and timely, but also easy for users to access and trust.

Within its ‘headline’ purposes, the SSIG seeks to improve the operation of the market. In the SSIG’s view this will be best progressed by ensuring all stakeholders have ready access to relevant cost-effective information upon which to base current and future decisions, and for there to be clarity, traceability and accountability for past decisions.

Acknowledgment

The SSIG thanks the Financial Accounting Standards Board for inviting comments on this important topic and would like to acknowledge the challenges in developing cost-effective policy in its conceptual framework project.

The SSIG considers the role of the FASB will become increasingly important, particularly in regard to enhancing public access and trust in external reports, which in due course should help maximise the operation and effectiveness of national and international markets.
Broad Principle-based Comments

In response to the invitation to comment, the SSIG wishes to bring to the attention of the FASB the following key issues and/or recommendations:

1. Changes to standards should not be made in isolation without a detailed understanding of the wider implications and the different legal and policy frameworks and objectives around the world. The key objective must be to provide a 'true and fair view' to the investing public and the public at large. In the case of economic, environmental and social effects; the terms 'investing public' and 'public' should be defined very broadly.

The landscape in which the FASB operates is extensive and the platforms upon which standards are expected to operate efficiently to meet the 'true and fair' criteria are significant. Examples of other mechanisms for 'serving the investing public' and 'public' include taxation regimes, industry generated standards (e.g. risk management standards, quality standards, Global Reporting Initiatives), and central and local Government laws and regulations including for example various types of licensing, Production Permits and Resource Consents.

Many contingent assets and liabilities relate directly to these matters and among them are environmental and social effects. Therefore, the mechanisms for managing those effects are a key aspect of uncertain assets and liabilities.

The American system for managing and reporting effects is largely focused on 'outputs and waste', being a liability approach, whereas the European focus is on 'inputs', 'production limits' and 'use of current technology' in order to maximise eco-efficiency and reduce environmental effects. This latter approach places the emphasis on permits (or Resource Consents in New Zealand) that are approved and monitored at a regional level. It could therefore be argued that, in regard to environmental effects, the European approach places a fence at the top of the cliff whilst the American system positions ambulances strategically at the bottom.

The SSIG supports the European approach, as it is more likely to minimise negative environmental and social effects.

The SSIG considers the FASB 'invitation to comment' would have benefited from a more detailed analysis of the pros and cons and more examples of the practical implications for a range of entities - by industry, size and location.

2. That accounting practice and theory for 'uncertainties' should be aligned to current risk management practice and theory.

New Zealand and Australia have jointly issued a generic standard on risk management, AS/NZS 4360: Risk Management (2004). (A good reference is located at www.risksociety.org.nz/newsinfo.html.)

The standard is being used internationally in a many different settings to manage widely disparate types of risk. Many of the terms and approaches included in the standard would be useful in discussing accounting for contingencies, which is about managing entity financial risk.
Therefore, the FASB has an opportunity to provide a more universal language relating to risk management and a foundation for a wide range of professionals, operating at policy and operational levels within entities. For example, a discussion on uncertain assets and liabilities that uses common terminology among auditors, accountants, engineers and top management, would be exceedingly useful.

To this end, the SSIG suggests Paragraph 2, page 1 of the Invitation to Comment be changed from ‘the role of probability and uncertainty in defining, recognizing and measuring assets and liabilities’ to;

The Boards will discuss ‘uncertain assets and liabilities’, including the role of probability and uncertainty consequences in identifying, defining, recognizing, measuring and reporting assets and liabilities’.

consequences— Such an approach would remove the term ‘uncertainty’ (which does not make sense when aligned to probability) and make accountants discuss uncertainties in terms of probability and consequence (e.g. the magnitude).

identifying— Because of the need to report a ‘true and fair view’, the SSIG considers any discussion on uncertain asset and liabilities should focus on identification in a risk management context, as this is a key determinant in terms of both the preparation and verification of financial reports.

reporting— Reporting is also critical and the SIG considers it would be more helpful for the FASB to broaden this discussion into three types of reporting tools, being;

- **Provisions** — reporting an estimated dollar figure in the financial report
- **Notes** — reporting a potential event that; for example has a
  1. more than 50% **probability** of occurring
  2. **consequence** that would have a material effect on the financial accounts (e.g. what is the financial magnitude).
  3. may happen in the next 10 years — often referred to as a third element of risk — being the **time taken** that the risk can occur.

- **Management Commentary** — reporting in a purely narrative form about the future landscape of the business.

If such an approach was taken, accounting terms like;

- ‘probable’ align with risk management terms, like ‘probability’
- ‘value’, align with risk management terms, like ‘consequence’ and ‘financial effects’
- ‘contingency’ or ‘future events’ align with risk management terms, like ‘event’ — which can be certain or uncertain
- ‘recognition’ align with risk management terms, like ‘risk identification’
• 'prudence' and 'conservatism', align with risk management terms, like; 'precautionary principle'
• 'materiality' align with risk management terms, like; 'significant' risks and benefits and 'acceptable levels' of risk
• 'net value' align with risk management terms, like; 'aggregating risks' and 'weighing' positive negative effects.

Also, a closer alignment to risk management may assist in exploring alternative options for reporting. For example, it may be useful to compare and discuss options in a format like those represented in Tables 1 and 2 below;

Table 1: Reporting of Contingencies – from a consequence/ materiality perspective only

If 100% confident the event will occur – estimate and include in the Financial Figures.

Whereas, if probability and consequence where more clearly aligned, it could be argued annual reports may provide a more accurate and meaningful 'true and fair view' – for example Table 2.
3. That reporting standards be written to provide both a bottom line mandatory rule based approach with a voluntary top of the line principle based approach, in order for those entities attempting to reach high standards of reporting – as per the mission of the FASB.

As outlined in Figure 1 below, there is a significant gap between what an entity is legally required to report (e.g. minimum standard) as against actual annual reports produced (e.g. Citizenship and Sustainable Development Reports).

The dilemma for the FASB is 'a true and fair view' is interpreted very differently in different market places, so some reports may produce 'truer and fairer views' than others. For example, in order to meet the needs of socially responsible investors.

As this demand for higher standards is being driven by the investing public and the public at large, being an increasing significant part of the FASB target market (i.e. the publics identified on the FASB home page), the FASB, in order to remain relevant, must acknowledge this growing gap and provide voluntary guidance to entities wanting to report at this higher level.

FASB should also take cognisance of the needs of other stakeholders and their needs and aspirations for quality information. Among these are labour unions and communities.
4. That a principle-based approach underlie all financial reports preparation, but be sufficiently flexible to allow national and regional variations within such a framework to meet local legal requirements and public accountability obligations.

New Zealand uses the same set of financial standards for both the public and private sectors. Such an approach has been very successful from the point of view of report users and report preparers and for example enables accountants to readily move between sectors and simplifies education and training.

In regard to legal requirements, a higher standard of reporting is required of specific public sector entities. For example; Local government in New Zealand is required by the Local Government Act 2002 to include sustainability issues in its reporting and community consultation. Notably, a recent article by Frame et al.14 (2003), stated:

*The Act places a heavy emphasis on the need for local authorities to identify ‘community outcomes’ in order ‘to provide opportunities to discuss their desired outcomes in terms of the present and future social, economic, environmental and cultural wellbeing of the community’. The latter point is important in that it places an additional emphasis on local authorities to report on the expected effects of future actions.*
5. Reporting financial uncertainties forms part of a larger reporting function to a wide range of stakeholders.

Annual reports also provide narrative information in the form of management commentary and act as a way of rectifying previous inaccuracies, as well as alerting the reader to uncertain issues facing the entity.

The SSIG supports the FASB in reviewing the conceptual framework and the management commentary. To this end, FASB may be interested in the following;

The Environment Court in New Zealand ordered a company as part of a conviction for environmental non-compliance, to include specific details regarding a prosecution in its annual report (Nuplex Judgment 2003). This was a first time in New Zealand (and perhaps elsewhere) and adds weight to the value of Annual Reports, as key providers of social and environmental information. The Court’s sentencing notes are available at:

http://sustainablefuture.info/system/knowledge_base/includes/download_attachment.asp?id=999&table=Article

The Australian and New Zealand Standards have developed interim General guidelines on the verification, validation and assurance of environmental and sustainability reports – AS/NZS 5911 (Int):2005.


An example of the use of this standard can be seen at;

www.landcareresearch.co.nz/publications/annualreport_0405/tonkin.asp.
End Note

Thank you for taking the time to read and consider this submission.

Importantly, we wish to emphasise the views expressed are the consensus views of the undersigned members of the Sustainability Special Interest Group committee. They are not necessarily the views of the New Zealand Institute of Chartered Accountants (the Institute) and in no way purport to be views of the Institute or its membership. In the event that this Invitation to Comment progresses to an Exposure Draft, the Committee looks forward to considering and presenting a more detailed submission.

Thank you for inviting comments. If there are any questions or queries, please do not hesitate to contact the SSIG via;

Wendy McGuinness
P O Box 24222
Wellington
New Zealand
wmcg@sustainablefuture.info
0064 21 781 200

Ray Skinner
Co-convenor Sustainability Group
Sustainability Matters
"Business achieving a tomorrow for tomorrow's children"
Phone: Office hours Mon - Wed (09) 302 5390; Methodist Mission Northern
All other times (09) 443 0773
eMail: ray@sustainabilitymatters.co.nz
Web: www.sustainabilitymatters.co.nz

Denis H. Bourke
Senior Lecturer
The Open Polytechnic of New Zealand
Private Bag 31-914
Lower Hutt, New Zealand
e-mail: denis.bourke@openpolytechnic.ac.nz
phone: +64 +4 913-5723
fax: +64 +4 913-5656