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Committee	**Policy, Finance and Strategy**
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Changes in Financial Reporting Standards in New Zealand

1. Purpose

To advise the Committee of the impending changes to Financial Reporting Standards in New Zealand and the likely impact of such changes on the Council's financial statements and supporting systems/processes.

2. Background

In accordance with the requirements of the Local Government Act 2002 all local authorities in New Zealand are required to comply with generally accepted accounting practice (GAAP) in New Zealand. This has been the case for many years.

Compliance with GAAP means:

- Complying with approved financial reporting standards, as far as those standards apply to the reporting entity.
- In relation to matters for which no provision is made in approved financial reporting standards and that are not subject to any applicable rule of law, accounting policies that are appropriate in relation to the circumstances of the reporting entity and have authoritative support within the accounting profession in New Zealand.

In New Zealand we operate on the basis of a two tier system for the development and approval of financial reporting standards.

To date, the Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of NZ has developed all existing standards (although the system is set up to enable other bodies to develop financial reporting standards) and the Accounting Standards Review Board (ASRB), an independent Crown entity, has approved all such standards.

All existing financial reporting standards on issue in New Zealand have been developed specifically for application in the New Zealand environment. During the development process the FRSB has drawn relevant material from around the world including accounting standards issued by the two major international standard setters:

- The International Accounting Standards Board (IASB) and its predecessor the International Accounting Standards Committee, which develops standards for profit oriented entities in the private sector.

- The International Federation of Accountants Public Sector Committee (IFAC PSC) which develops standards for entities in the public sector.

Where appropriate, the FRSB has amended the international material or developed entirely new material so as to achieve a set of standards that suit the New Zealand environment.

New Zealand has long been seen as a world leader for the quality of financial reporting by our public sector and we are one of only a handful of countries from around the world where public sector entities, including local authorities, are required to report both budget and actual figures on an accrual basis in accordance with GAAP. (i.e. as a local authority GWRC is required to comply with GAAP in our LTCCPs, Annual Plans and Annual Reports).

In addition to developing our own standards for application in the New Zealand environment the Institute of Chartered Accountants of NZ has made a significant contribution over the years to the development of international accounting standards by both the IASB and the IFAC PSC.

I am currently the New Zealand representative on the IFAC PSC. The aim of the Institute of Chartered Accountants through this process has been to influence the nature of standards and other guidance developed internationally. This remains a key objective of the Institute.

One of the key features of standard setting in New Zealand has been our development of sector neutral standards which apply to reporting entities across all sectors. This means that our standards have been capable of application by the private sector, the public sector (including local authorities) and the not-for-profit sector. This has been a significant advantage to preparers, auditors, stakeholders and other users of financial reports in New Zealand as there has been one set of rules for all reporting entities to follow.

In December 2002, the ASRB announced that New Zealand entities would be required to apply new standards, based on International Financial Reporting Standards developed by the IASB, for reporting periods beginning on or after 1 January 2007. Entities were given the option of applying the new standards as early as reporting periods beginning on or after 1 January 2005 (in the case of local authorities this translates to the 2005/06 year). The overriding rationale for this decision was that long term there should be only one set of accounting standards in the world and that New Zealand was too small to continue to do our own thing in an increasingly global economy. This decision signalled a significant change to the development of financial reporting standards in New Zealand, one which is currently in the process of being implemented.

In effect, the entire set of financial reporting standards in New Zealand is being replaced by a new set of standards, based more closely on the standards issued by the IASB.

The conversion process being followed by the FRSB and ASRB uses each international standard as the starting point, with NZ adaptations made subject to a tightly controlled set of criteria. The intention of the two Accounting Standards Boards in New Zealand is to retain the international standards intact, but to add New Zealand specific material to ensure that the new set of standards can continue to be applied by all reporting entities, not just those in the private sector whom the IASB standards are primarily directed at.

By retaining the international standards intact reporting entities in New Zealand will be able to claim compliance with International Accounting Standards, a key driving force behind the ASRB's 2002 decision for New Zealand to adopt international standards. The key challenge for the FRSB and ASRB has been to make sufficient New Zealand adaptations to enable all reporting entities (including local authorities and other public benefit entities) to be able to apply the standards, while not in any way compromising the standards for private sector entities.

3. What is the Auditor-General's view of the proposed changes?

Councillors should have already received, via the Councillors' Bulletin, a copy of the latest report to Parliament by the Auditor-General, in relation to local authorities. Section 2.1 of that report contained the Auditor-General's views of the decision of the ASRB that New Zealand would adopt international standards and the implications of that decision for the New Zealand local authority sector. (Refer to **Attachment 1** of this report).

It is fair to say that the Auditor-General has some concerns about the process being followed and about the potential impact on local authorities in New Zealand of the move to a new set of standards.

Notwithstanding these concerns the processes being followed by the FRSB and ASRB are well advanced with the majority of new standards approved as "pending standards" by the ASRB. In other words, the process of change is nearly complete and the release of a new set of financial reporting standards in the near future is now a realistic prospect, something which looked an extremely tall order when the ASRB made its announcement in late 2002!

No doubt there will be further challenges facing the FRSB and ASRB as the implementation date nears, and subsequent to that as the suite of standards is further developed by the IASB.

However, having made the commitment to more closely follow international standards New Zealand must now keep pace with the international developments and continually update our New Zealand standards as a result. Perhaps more importantly, we will need to continue to influence developments internationally so that the quality of standards produced in future is such that adoption of these standards continues to be in the best interests of New Zealand.

In summary, local authorities in New Zealand must now prepare for the impending replacement of all Financial Reporting Standards because the new standards are "coming ready or not".

4. When do the new standards take effect?

For the reasons outlined below the majority of local authorities in New Zealand are expected to adopt the new standards for the reporting period ending 30 June 2007 (i.e. the 2006/07 financial year which is one year earlier than required).

However, as comparatives are required to be presented on the same basis of accounting, local authorities will need to apply the standards, albeit retrospectively, for the 2005/06 year. In order to achieve this each local authority will need to restate its balance sheet at 30 June 2005 using the new accounting standards.

As noted above, all local authorities are expected to apply the new standards one year earlier than the latest available date because of the relationship between the requirement to produce a LTCCP for the 10 years commencing 1 July 2006 and the strong desirability of planning and reporting on the same basis of accounting.

If a local authority chose to delay adoption until the latest possible date, the first year of the 2006 LTCCP would contain prospective financial information using the old standards whereas the remaining 9 years of the LTCCP would need to be on the new standards.

This is not seen as a very sensible thing to do and for that reason I expect the majority, if not all, local authorities in New Zealand, will choose to adopt the new standards for the 2006/07 year, thereby lining up with the LTCCP period commencing 2006/07 (and the following 9 years).

We therefore have until approximately December 2005 to determine the impact of the new standards on the Council's June 2005 balance sheet and to retrospectively restate the June 2005 balance sheet as a key input into the LTCCP commencing on 1 July 2006.

5. What are the likely impacts of the changes in the standards?

Attached as **Attachment 2** to this report is an article which appeared in the April 2004 Chartered Accountants Journal, which discusses the likely impact of the new standards on reporting entities in New Zealand.

The article provides a good general overview of the process being followed by the Institute and the likely impacts across the broad range of reporting entities in New Zealand.

The key messages to emerge from the article are that “the impact on a given entity will reflect its unique set of transactions and circumstances” and “there is also the not insignificant task facing accounting professionals of becoming familiar with the requirements of the new standards and bringing to those standards the professional judgement required to apply them to the circumstances of each entity”.

In other words, there is unlikely to be a boiler plate solution able to be applied by entities in order to comply with the new standards – it is up to each entity to determine the impact of the new standards on its unique set of circumstances.

Since the article was written the FRSB and ASRB have continued to work on the new standards. However, the full set of standards is not yet complete so it is not yet possible to be definitive about the full extent of changes which will arise as a result of the introduction of the new standards.

6. What are the likely impacts on GWRC’s financial statements?

Based on the work that we have completed to date the new standards are likely to have the following general types of impact on the Council:

⇒ Some of our current accounting treatments giving rise to figures in the Council’s balance sheet and operating statement will need to change

⇒ Some of our current note disclosures will need to change, with a number of additional disclosures required.

⇒ Some of our systems and processes may need to change in order to provide the required information.

6.1 Potential High Impact changes in accounting treatment

In terms of the high impact areas that we have identified likely changes in accounting treatment in the following areas:

- **Forestry Investment**

  Currently Council’s forest investments (plantation forestry and reserve forestry) are not measured at fair value on the face of the Council’s balance sheet. Rather, fair value of Council’s forestry investments is noted within the notes to the financial statements as additional information, with the balance sheet recording a lower book value of the forestry investment.

  The new standards will require forestry investments to be valued at fair value on the balance sheet, with changes in fair value recognised as revenue or expenditure in the income statement (depending on whether the fair value has increased or decreased).

This will lead to an increased value for the forestry investment being shown on the Council's balance sheet and increased volatility in future in Council's income statement.

- **Deferred Tax**

  The whole basis of deferred tax accounting is changing under the new standards, which will affect both the accounting treatment and tax note disclosures of Council's tax paying subsidiaries, in addition to affecting the Council group financial statements.

  As a general rule the new method of accounting for deferred tax will result in increases in deferred tax assets or liabilities. This could have a significant impact on CentrePort and on the other WRC Holdings group of companies.

- **Financial Instruments**

  Currently New Zealand does not have a financial reporting standard covering the recognition and measurement of financial instruments. Financial instruments encompass financial assets (e.g. cash, debtors), financial liabilities (e.g. creditors) and derivatives (e.g. interest rate swaps).

  The adoption of the new standard on recognition and measurement of financial instruments, as part of adopting the new suite of international standards, is likely therefore to significantly impact on both the Council and its subsidiaries as follows:

  ⇒ **Derivatives (e.g. interest rate swaps)**

  At present derivatives are not recorded at fair value although we do note the fair value in the notes to the financial statements.

  The new standards require derivatives to be valued at fair value with the change in fair value taken to the income statement unless strict rules for hedge accounting are met, in which case the accounting treatment can be varied to take changes in fair value to equity.

  The issue for officers to further advise the Council on is, is hedge accounting warranted (ie. do the benefits outweigh the costs) or are we better just to fair value all derivatives and take all changes in fair value to the income statement?

  ⇒ **Financial Assets – Council's $25 million advance to the Stadium Trust**

  Currently the Council's advance to the Stadium Trust is carried at cost i.e. the Council records an asset of $25 million in its books. The advance to the Stadium Trust has no fixed repayment date and is interest free.

The new standards on financial instruments may enable the Council to continue to carry the loan to the Stadium Trust at cost i.e. still at $25 million. If not the loan will need to be valued at fair value which will be at considerably less than $25 million given the nature of the advance. The best way to think about fair value is to try and determine what a third party would be prepared to pay for the asset.

This would be a significant issue for the Council to manage given the political sensitivities around the $25 million advance and the fact that the Council expects repayment of this amount in the future. Further work is required to investigate this issue once the new financial instruments standard has been finalised.

- **Other changes**

  There are a range of other changes which are likely to arise form the adoption of new accounting standards including:

  - Measurement of investment properties will change from net current value to fair value (i.e. disposal costs will no longer be deducted, resulting in a higher value being recorded for the Regional Council Centre). This will affect Pringle House Ltd.

  - Development margins on investment property will need to be recognised in full, on completion, within equity.

    Currently, this is progressively recognised as revenue in the income statement. This may affect CentrePort Ltd, depending on its approach to future development of its Business Park.

  - Liability classification (term vs current) will change in certain circumstances e.g. where debt matures after balance date but has been refinanced before adoption of the financial statements such debt will be classified as a current liability as opposed to our present practice of recognising it as at term liability.

  - The criteria for recognition of provision for dividend where dividends are declared before balance date are likely to be further tightened. This could affect the WRC Holdings group, including CentrePort.

  - Changes in accounting policies will be required to be presented as retrospective adjustments with changed comparatives.

  - Entities presenting interim financial statements (e.g. 6 monthly results) will be required to estimate the full year tax rate (as opposed to the tax applying to the interim period). This could affect CentrePort.

6.2 Likely changes in disclosure

Adoption of new Accounting Standards is likely to result in a number of changes to disclosure e.g:

- disclosure of any write down in inventories recognised as an expense.
- disclosure of cost of sales (only really applicable in respect of CentrePort)
- prohibition on disclosure of extraordinary items
- disclosure of judgements made by management in applying accounting policies that have the most significant effect on the financial statements
- increased disclosure around service concession arrangements (e.g. Build, Own, Operate and Transfer schemes)
- increased disclosure around key management personnel compensation (key management personnel includes Directors)

6.3 Potential changes to systems and processes

Until the new set of standards has been finalised it is difficult to be specific about the nature of changes which will be required to Council's systems and processes.

However, based on the potential changes which have been identified in this report there are three main types of changes:

- **Increased use of fair values in financial reporting**

  In the majority of cases we already capture this fair value information but we make use of it in the notes to Council's financial statements rather than on the face of the balance sheet.

  Therefore, even though our accounting treatment will need to be different our existing systems and processes already capture the information necessary for us to be able to comply with the new standards.

- **Change to the basis of calculating deferred tax**

  Although this is a major change I expect that we will continue to rely heavily on our tax advisors for the calculation of deferred tax balances under the new standards.

  In the restatement of the 2005 balance sheet I expect that our key finance staff will need to work closely with our tax advisors. However, thereafter the new basis of calculation should form part of our normal year end processes.

- **New disclosures**

  Although there are a range of new disclosures that will be required to be made in order to comply with the new standards I expect that our existing systems and processes will be able to generate most of the information required.

7. What process is GWRC following to ensure compliance with the new standards?

I have established the following project team for the implementation of the new accounting standards:

- Chief Financial Officer (project sponsor)
- Paul Laplanche – Finance Manager (Project Manager)
- Kerry Saywell – Treasurer
- Marie Kitchener – Financial Accountant
- Jasmine Sim – Management Accountant
- Rachael Creasy – Accountant

The project team sees that the project has three broad phases:

1. Awareness
2. Evaluation
3. Implementation

1. **Awareness phase (present – December 2004)**

   We are currently in the Awareness phase where we are monitoring the progress of the FRSB and ASRB in developing and approving the new set of standards, and coming up to speed with the nature and extent of changes arising from the new standards.

   This involves project team members attending courses and researching potential high impact areas, such as those identified earlier in this report.

   Further initiatives under the Awareness phase include liaising with other Councils in the Wellington Region and liaison with the SOLGM Financial Management Working party which is planning to assist with a "travelling roadshow" in a similar way to the introduction of the new Rating legislation several years ago.

   We also expect to maintain a close liaison with our auditors on this issue over the next 12-18 months as the nature and extent of changes from the introduction of new standards becomes clearer.

2. **Evaluation phase (December 2004-June 2005)**

   Once the new standards have been released as "approved standards" by the ASRB the Council will be in a better position to fully evaluate the nature and extent of changes required to:

   - Accounting treatments
   - Disclosure
   - Systems/processes which support the finance function

3. **Implementation phase (June 2005 →)**

   As noted earlier in this report the first step in the implementation of the new standards will be the restatement (albeit retrospectively) of the Council's balance sheet at 30 June 2005. We expect to conduct both the June 2005 and June 2006 year end processes as normal by applying the existing accounting standards. However, as we will need comparative figures for the 2005/06 year based on the new standards we will also need to put processes in place to either run parallel accounting records or retrospectively restate the 2005/06 year and the 30 June 2006 balance sheet using the new standards.

8. Where to from here?

Much work remains to be done but planning is as advanced as it can be given the fact that the set of new standards has yet to be finalised.

I believe that it will be a good discipline for the project manager/project sponsor to report to the Committee on a regular (perhaps quarterly) basis in future to enable the Committee to track the progress of this organisationally significant project.

9. Communications

Officers plan to include a section within the 2004 Annual Report explaining the Council's approach to the implementation of new accounting standards.

No other communication is considered necessary at this time.

10. Recommendation

That the Committee recommend that the Council:

(1) receive the report and note its contents.

Report prepared by:

Greg Schollum
Chief Financial Officer

Attachment 1:	Changes in Financial Reporting Standards (Chapter from the Controller and Auditor-General's report "Local Government: Results of the 2002/03 Audits")
Attachment 2:	IFRS – the New Zealand way (Article from the Chartered Accountants Journal April 2004)