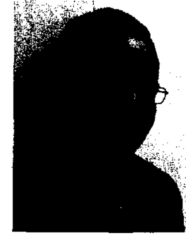
IFRS – the New Zealand way



*Alan **Teixeira** assesses the impact for New Zealand entities moving to International Financial Reporting Standards*

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THE Financial Reporting Standards Board (FRSB) is currently preparing and exposing the set of Financial Reporting Standards (FRS) that will enable New Zealand entities to assert compliance with International Financial Reporting Standards (IFRS). This set of standards will be known collectively as NZ IFRS and will be available for adoption for financial reports that form part of any annual reporting period beginning on or after 1 January 2005.

Adoption of NZ IFRS will be mandatory for financial reports that cover part of any annual-reporting period beginning on or after 1 January 2007, replacing the current set of New Zealand developed FRS.' We are therefore about to enter a period where we will have parallel sets of standards under New Zealand Generally Accepted Accounting Practice (NZ GAAP).

The change from the existing NZ standards to the FRS-compliant standards will see differences in the structure and content of the core financial statements, changes in the information disclosed in the notes and differences in the way many of the elements are measured.

The impact on internal systems to manage the data and generate the information required, and the impact on the reported performance and position, can be significant. Transitioning from the existing standards to the new standards also requires all comparatives to be presented in accordance with the new standards, along with an explanation of the impact of the change.

An entity electing to comply with NZ IFRS that has a 31 December balance date has already passed the opening balance date for its comparatives, so it is in effect working with the new standards. What makes the task even more challenging is that the International Accounting Standards Board (IASB) is only just finalising some of these standards. Despite this, the task of exposing and preparing the final New Zealand versions of these standards is scheduled for completion soon after June this year.

The purpose of this article is not to frighten, but to heighten awareness of the impact of the move to IFRS-compliant financial statements.

Assessing the impact of the new GAAP

At a very basic level, the terminology is different. IFRS were developed for profit-oriented entities and, for example, use the terms balance sheet and income statement. This does not compel New Zealand entities to revert to these terms, but the terms we learnt to forget are commonplace in the new standards!

Primary financial statements

What information is presented in the main financial statements is a primary focus of NZ IFRS. The new standards specify the minimum disclosures that must be made on the face of the core statements. For example, cash and cash equivalents, trade and other receivables, property, plant and equipment, investment property, intangible assets, and inventories must all be disclosed on the face of the statement of financial position. There has been a tendency for New Zealand financial statements to have a more minimalist approach with the detail provided in the explanatory notes. Under the new standards, presenting certain information in notes will simply not be good enough.

There are also many subtle changes. For example, the distinction between current and non-current inventory will disappear because the new standards base classification on how assets fit into the operating cycle. This means wine inventory, for example, will be classified as a current asset even if it has a maturity period covering several years. Similarly, the new standards distinguish between investment property, and property, plant and equipment in a manner that differs from existing NZ GAAP.

Changes in accounting policies will be recognised retrospectively by adjusting the prior period amounts and opening equity, rather than recognising the impact in the period the change takes place.

It will no longer be permissible to classify an activity as extraordinary but, given the narrowness of the current New Zealand definition, the impact of removing this category should be negligible. We may also see New Zealand entities reporting in US dollars, Australian dollars or the euro since there is a free choice of currency presentation.

Financial instruments

Under current NZ GAAP, it has been common for instruments to be classified as debt or equity depending on the dominant characteristics. The new standards take a different approach. If an instrument has some debt and equity characteristics, then it will be necessary to separate these components. A common example is convertible shares that include a contractual payment stream (such as a fixed dividend stream). Such instruments are commonly deemed to have a debt component that will need to be recognised. c

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The impact on individual entities could be substantial, particularly because existing debt and equity will need to be classified under the new requirements, It is likely that many entities will need to recognise as a liability certain instruments they currently classify as equity. Certain types of entities, such as cooperatives, will be particularly affected because of the characteristics of the instruments they issue.

The accounting treatment of financial instruments under current NZ GAAP is diverse. It is therefore difficult to assess the likely average impact of complying with the new requirements on the reported performance and position of New Zealand entities. Among the general differences that entities face is a requirement to designate financial instruments into categories (such as "held-to-maturity" or "at fair value through profit or loss") that can be used to determine the measurement basis and how gains or losses are recognised.

For unhedged financial instruments, all derivatives must be measured at fair value and the changes in fair value taken to income, Certain financial assets or liabilities will have to be carried at fair value rather than cost. Examples include loans and advances that do not have determinable payments and are not actively quoted. Certain financial assets or liabilities will have to be carried at amortised cost using the effective interest method.

There may be circumstances where the carrying amount determined by an entity under these methods will differ from the carrying amount determined under the limited guidance provided by NZ GAAP. The result of these changes is that reported financial performance is likely to be more volatile under the new standards than under current NZ GAAP. There are also very strict guidelines on hedge accounting, including requirements to complete compliance documentation.

Assets

Accounting for intangibles has attracted attention because some intangibles that are currently recognised under NZ GAAP will have to be removed from the financial statements under IFRS Intangible assets may not be revalued unless there is an active market in that asset. IFRS explicitly state that an active market cannot exist for newspaper mastheads and brands, for example, so they cannot be carried at revalued amounts.

This is not to say that intangibles disappear – there will be those that are traded actively Some have argued that New Zealand's fishing quota may meet the active market test. It will also be permissible to capitalise costs on software and other developments. Purchased intangibles are also permitted. In fact, on acquiring a subsidiary, it is a requirement to recognise identifiable intangibles that have been purchased, including customer lists, brands and mastheads. These assets will then need to be amortised.

In contrast, any goodwill in the acquisition will not be able to be amortised. Instead, IFRS will require goodwill to be subject to an impairment test. The new standards provide considerable guidance on assessing whether assets (including tangible assets) have been impaired.

Property, plant and equipment

Significantly more information is required to be disclosed about property, plant and equipment under the new standards. For example, there is a requirement to disclose an analysis of the movements in each class of asset.

One fundamental change is the way revaluations are managed. The new standards manage revaluation on an asset-by-asset basis. The effect is that any revaluations that cause an individual revaluation reserve to have a deficit are taken to income. Under current NZ GAAP, they are offset within a class and only a net deficit is taken to income.

Income tax

The new standard under NZ IFRS will have a much wider basis for determining the deferred tax balance than SSAP-12. The new treatment focuses on temporary differences whereas SSAP-12 focuses on timing differences.

Temporary differences are those between the carrying amount of an asset or liability in the statement of financial position and the tax base of that asset or liability, and give rise to deferred tax assets and liabilities that may be recognised as assets and liabilities, respectively. Timing differences are primarily those between the accounting results and taxable income for a period that originate in one period and reverse in one or more subsequent periods, respectively. Under our existing standard, deferred tax expense is driven by accounting income. In contrast, under the new standard the deferred tax expense is the movement in the deferred tax balance over the period – a balance-sheet approach.

All timing differences will be temporary differences but not all temporary differences are timing differences. For example, the new standard will require the recognition of the deferred tax associated with revaluations whether there is an intention to sell or not. This is not common under current NZ GAAP For those entities that revalue assets, the implications could be significant.

The new standard also prohibits the use of the partial method and discounting of the deferred tax liability. IFRS also require more information to be disclosed ▸

than SAP-12. For example, there is a requirement to disclose each type of temporary difference in respect of the amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented, and the amount of the deferred tax income or expense recognised. Does, for example, the deferred tax relate to temporary differences on depreciation, accruals or capitalisation?

Under the new standards, recognition of deferred tax assets, including losses carried forward, is based on whether it is probable that the asset will be realised in the foreseeable future. SSAP-12 imposes a more rigorous "virtual certainty" test.

Summary

One of the most important messages is that the impact on a given entity will reflect its unique set of transactions and circumstances. In some cases, there will be minimal impact on the reported performance and position of an entity, though the disclosures are likely to differ. In other cases, the financial landscape presented will change significantly. The examples discussed here represent only a small sample of the changes the new standards will bring.

Analysts and investors will need to be able to discern whether those changes reflect risks not previously reflected in the financial reports or are a different way of reporting previously known risks. Preparers will need to be able to explain the impact to the investment community, and ensure that contracts and loan agreements relying on accounting numbers are able to weather the transition. 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.

Footnotes

1. The Journals July 2003 issue contains several articles outlining the development of NZ IFRS which are based on IFRS
2. NZ standards include Financial Reporting Standards and Statements of Standard Accounting Practice, and are referred to as existing standards
3. The discussion in this section is not intended to provide a comprehensive analysis of all differences between the existing and new standards, Further, the set of standards is not yet finalised, so the comments contained here may be affected by subsequent changes
4. The sector-neutral terms are used in this article to reflect their common and expected continued use, given that NZ IFRS are sector neutral and entities will continue to report under the Financial Reporting Act 1993 (which also uses sector-neuttal terms) ■

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