
**IMPLICATIONS FOR COUNCIL OF NEW AND
PROPOSED FINANCIAL REPORTING STANDARDS**

1. PURPOSE

The purpose of this regular report is to inform the Subcommittee of new and proposed Financial Reporting Standards and their likely impact for the Council.

2. RECOMMENDATIONS

It is recommended that the Subcommittee:

1. *Receive the information*
2. *Note the developments in New Zealand generally accepted accounting practice (GAAP) since the Subcommittee meeting in March 2005*
3. *Note that a full briefing on NZ IFRS will be provided to all Councillors during phase three of the project.*

3. BACKGROUND

The Local Government Act 2002 requires the Council to comply with GAAP in preparing the Annual Report. GAAP is defined by the Accounting Standards Review Board (ASRB) to encompass all applicable Financial Reporting Standards (FRSs) and other sources of appropriate authoritative support (for example; exposure drafts of financial reporting standards, international accounting standards etc).

Council Officers have undertaken to report to the Subcommittee on a regular basis in relation to any new FRSs and any exposure drafts currently on issue by the Institute of Chartered Accountants of New Zealand (the Institute). This report outlines new developments in GAAP since the last Subcommittee meeting on 29 March 2005.

4. DEVELOPMENTS IN FINANCIAL REPORTING STANDARDS

4.1 History

The New Zealand ASRB announced on 19 December 2002 that IFRS would apply to financial reporting by public and private sector entities in New Zealand from 1 January 2007 (with the option to adopt early from 1 January 2005). This decision was taken following the announcement in August 2002 by the Australian Financial Reporting Council (FRC) to require Australian reporting entities to adopt IFRS in 2005.

The implications of the adoption of NZ IFRS will be significant for New Zealand reporting entities, including the Council. Local authorities will adopt NZ IFRS for external reporting purposes for the accounting period ending 30 June 2007. While the adoption date may seem a long way away, there is a significant amount of preparation required. In addition, the requirement for comparative figures to comply with NZ IFRS in the year of adoption means that the Council will need to be in a position to comply with the new standards from the beginning of the prior period (ie period ending 30 June 2006).

On 24 November 2004 the ASRB approved the suite of NZ IFRS. This means that there is now a reasonably stable platform of standards which reporting entities can use to assess the implications of implementation. However, the approved NZ IFRS are subject to change and we would expect further amendments to reflect international developments as well as the issuance of further guidance material for public benefit entities. We will maintain a watching brief over developments in this area and keep the Sub-Committee informed of any exposure drafts which may impact the Council.

4.2 Exposure Drafts on Issue

The Council makes submissions on exposure drafts where there is potential for a significant impact on either the Council as a reporting entity or the level of funding provided by ratepayers. We also consider whether the proposals are appropriate, in our opinion, from a standard setting perspective.

No submissions have been made on behalf of the Council since the last Subcommittee meeting. As the stable platform of NZ IFRS has now been approved, there are now less exposure drafts on issue. The following exposure drafts are currently open for comment:

- IFRIC Draft Interpretation D16: *Scope of IFRS 2*
- IFRIC Draft Interpretation D17: *IFRS 2 Group and Treasury Share Transactions*
- IFRIC Draft Interpretation D15: *Reassessment of Embedded Derivatives*
- ED-103: *Prospective Financial Information*
- ED-101 New Zealand Application Guidance: *When is an Entity a Public Benefit Entity?*

Council Officers expect to submit on the final two exposure drafts listed. ED-101 is of particular significance for the Council as it determines which entities can apply the public benefit entity (PBE) exemptions within the NZ IFRS.

We will provide copies of any submissions made at the next Sub-Committee meeting.

5. IFRS PROJECT

5.1 Update

To prepare the Council for the transition towards the implementation of NZ IFRS, the Council has established an IFRS working group within the Financial Accounting Team. Over the past eighteen months, this group has been reviewing the exposure drafts of the NZ IFRS and identifying the significant financial implications for the Council. We have also prepared submissions on the exposure drafts as appropriate and reported these to the quarterly Audit and Risk Management Sub-Committee meetings.

Since the suite of NZ IFRS was approved by the ASRB, the project team have initiated the second phase of our project plan. This has involved:

- 1 Working with PricewaterhouseCoopers (PWC) to undertake a series of workshops to highlight potential conversion issues
- 2 Reviewing approved standards and analysing the implications for the Council's financial statements and accounting policies (known as "component evaluations"); and
- 3 Developing a detailed action list to ensure compliance with the new standards, incorporating required changes to accounting policies, information systems and reporting.

The workshops, involving representatives from Council and our subsidiary entities (such as the Museums Trust, Capacity, Wellington Cable Car Limited etc) were completed during the first quarter of 2005. During the period since the last Subcommittee meeting, Council Officers have been focusing on steps two and three above.

The component evaluations have been completed for each of the NZ IFRS and consider the application of the standard within the Council environment. The evaluation template analyses (by standard):

- Current accounting policy and practice
- A summary of the applicable NZ IFRS
- The impact of the new standard (financial, reporting and systems)
- NZ IFRS accounting policy choices (if any)
- Relevant issues raised in the workshops
- Suggested revised accounting policy
- Actions required

Completion of these evaluations has proved extremely beneficial. The templates have been completed predominantly in-house, utilising the skills of our IFRS project team. This has enabled us to up skill the team, and develop a strong base knowledge of NZ IFRS within the finance group. The completed evaluations will also form the basis of our accounting policy formulation, providing a clear reference point and audit trail for our external auditors.

The project team is now in the final stages of phase two, which involves collation of the component evaluations and the compilation of an overall action plan. This will then lead us into phase three of the project, which is discussed in paragraph 5.3 below.

5.2 Significant Issues

Phase two of the project has highlighted the significant implementation issues for Council. Overall, the most significant implication for the Council's financial statements will be an increase in disclosure requirements. While we were initially concerned that the application of NZ IFRS would result in a significant increase in volatility in the Statement of Financial Performance, our preparatory work has indicated that we will be able to mitigate the effects for the Council through the application of hedge accounting (for changes in fair values of derivatives) and the PBE exemptions (changes in valuation of property, plant and equipment).

As a result, any significant impact of NZ IFRS on the Statement of Financial Performance is likely to be limited to changes in the fair value of investment property (previously taken to reserves), potential impairment losses in the case of community loans provided on favourable terms and fair value changes in derivatives which do not meet the criteria for hedge accounting.

PWC has provided us with their opinion on the top conversion issues for the Council. An extract from PWC's report, including an outline of the key implications is included in Appendix One.

5.3 Proposed actions

As previously noted, the Council is at the leading edge of the sector in relation to preparedness for NZ IFRS. We expect to complete phase two of the project by 30 June 2005, significantly in advance of many other local and central government entities.

The completion of phase two will provide the working group with a clear and comprehensive strategy of actions and responsibilities for implementation. This will then lead into the third phase of the project. The tangible products from phase three will include:

- Development of the NZ IFRS Statement of Accounting Policies;
- Completion of a trial run of NZ IFRS financial statements for the Sub-Committee's review; and
- Preparation of an opening balance sheet reconciliation between existing NZ GAAP and NZ IFRS as at 1 July 2005.

We will continue to report the progress of the project to the Subcommittee on a quarterly basis. We would anticipate the achievement of some phase three deliverables during the next quarter.

5.4 Training for Councillors

At its 29 March 2005 meeting, the Subcommittee requested Officers to conduct an NZ IFRS briefing session for all Councillors. Given the highly technical nature of the information within the NZ IFRS, we believe it would be most effectively presented in the context of live examples of the impact of the change (ie mock-up Council NZ IFRS financial statements.)

We therefore recommend that this briefing is deferred until the completion of the NZ IFRS Statement of Accounting Policies and template financial statements. It is anticipated that these will be completed in the final quarter of 2005.

6. CONCLUSION

Since the last Subcommittee meeting, the Council's IFRS working group has completed a significant amount of preparatory implementation work. We remain at the forefront of the sector in relation to our planning, and as a result we are well placed to ensure we can pro-actively assert compliance.

We anticipate completion of phase two of the project by 30 June 2005, providing us with a clear and comprehensive plan for implementation. We will continue to report developments to the Subcommittee on a quarterly basis.

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EXTRACT FROM PWC REPORT:

TOP CONVERSION ISSUES

Public benefit entities

Public benefit entities are reporting entities whose primary objective is to provide goods or services for community or social benefit. The determination of whether an entity is to be classified as a public benefit entity requires the application of professional judgement. As public benefit entities have a number of specific recognition and measurement requirements that they must follow, and are excluded from some of the disclosure requirements of NZ IFRS, WCC will need to determine which entities within the WCC group meet the definition of a public benefit entity, ensure that public benefit entities apply the specific recognition and measurement requirements that apply to them and determine which disclosure requirements, if any, to take advantage of. Where a public benefit entity has transactions for which the recognition or measurement requirements in NZ IFRS differ to those in the International Financial Reporting Standard (“IFRS”) on which it is based, or where it elects to take advantage of the disclosure concessions provided to public benefit entities by an NZ IFRS, it will not be able to claim compliance with IFRS, although it will still be able to claim compliance with NZ IFRS.

First time adoption of NZ IFRS

On consolidation, WCC will have to ensure that all entities within the WCC group have used consistent accounting policies when preparing their financial statements, or that any differences in accounting policies are well documented so that appropriate adjusting entries can be made on consolidation. This means that WCC will have to develop NZ IFRS accounting policies for itself and the WCC group and that these policies will have to be well documented and effectively communicated to all entities within the WCC group.

In addition, when WCC first adopts NZ IFRS it will have to determine which of the optional exemptions available under NZ IFRS 1: *First-time Adoption of New Zealand Equivalents to International Financial Reporting Standards* (“NZ IFRS 1”) it will apply.

Community loans

WCC advances a number of “community loans”. The terms of these loans vary, particularly in relation to repayment terms and interest rates charged. In addition, WCC provides various other entities with guarantees. These loans and guarantees will need to be brought onto the balance sheet at the appropriate value. In some cases, the fair value

of such financial instrument may be less than their face value, which would result in a reduction to opening equity.

Financial instruments / hedge accounting

On implementation of NZ IFRS, WCC will need to recognise all derivatives on the balance sheet and measure them at fair value. If an entity meets the cash flow hedge accounting requirements, changes in fair value can be recorded through a hedge accounting reserve in equity. If cash flow hedge accounting cannot be achieved, all changes in fair value must be recognised directly through the income statement.

Hedge accounting is optional under NZ IFRS. To obtain hedge accounting NZ IFRS requires hedge designation, documentation and effectiveness testing. Designation of derivatives to specific transactions is required. Hedges are expected to be highly effective in managing the identified risk being hedged and effectiveness must be tested when entering into the derivative contract (prospectively) and at least every reporting period (both retrospectively and prospectively).

Investment property

WCC will need to develop guidance, for use by all entities within the WCC group, on the categorisation of properties as either investment properties or as items of property, plant and equipment. On the basis of that guidance, WCC and each of the entities within the WCC group will need to determine which properties, if any, should be classified as investment properties. This categorisation may have a significant impact on the financial statements of the WCC group, as investment properties must be revalued annually, with changes in the fair value recorded in the income statement.

Deferred tax

The NZ IFRS approach to deferred tax is conceptually very different to current NZ GAAP. NZ IFRS takes a balance sheet approach and deferred tax represents the tax effects of recovering and settling recognised assets and liabilities. The deferred tax currently recognised would change under NZ IFRS, due to the recognition of additional deferred tax amounts, principally on revalued items of property, plant and equipment, and due to the deferred tax consequences of recognising all financial instruments on the balance sheet.

Leases

NZ IFRS guidance on the classification of leases is similar to that under current NZ GAAP. WCC should reassess each of the various lease agreements in place when it adopts NZ IFRS to ensure that its classification as either an operating or a finance lease will be appropriate under NZ IFRS.

Property, plant and equipment

When adopting NZ IFRS, WCC will need to ensure that asset classes across the WCC group are carefully determined. Policies on the measurement basis for each of the asset classes will need to be developed and consistently applied across the WCC group because, on a group basis, if one asset within a class is revalued, all assets within the same class must be revalued.

Where assets held by entities that are not public benefit entities are revalued, revaluations will have to be accounted for on an asset by asset basis, which may require changes to the systems used to record property, plant and equipment values. In addition, where assets are revalued, those entities within the WCC group that are not public benefit entities will need to find a cost effective manner to calculate the carrying amount that would have been recorded if these assets had been accounted for using the historical cost method, as disclosure of this information is required under NZ IFRS.

Related Parties

The definition of a related party is wider under NZ IFRS and extends to include key management personnel, close family members and any entity related to these people. NZ IFRS requires detailed disclosure of the remuneration of directors and key management personnel and WCC will need to ensure that systems are in place to gather this information.