Government's transition to New Zealand equivalents to International Financial Reporting Standards (NZ IFRS)

QUESTIONS AND ANSWERS TO ACCOMPANY MEDIA/ANALYST BRIEFING ON 9 MAY 2007

These Q&A should be read in conjunction with the presentation given to media and analysts on 9 May, the provisional NZ IFRS financial statements to December 2006, and the tables summarising changes identified in these statements. This information is available at www.treasury.govt.nz/nzifrs.

Rationale

1 Why is the Government adopting NZ IFRS? What are the benefits?

All reporting entities, including the Government, must apply to their financial reporting the accounting standards approved by the Accounting Standards Review Board (ASRB). In 2002 the ASRB decided that reporting entities should use NZ IFRS for periods commencing after 1 January 2007. New Zealand's adoption of International Financial Reporting Standards (IFRS) follows that of many other countries, including Australia.

IFRS provides a more comprehensive, more widely accepted and more robustly tested set of standards. Accordingly, adoption of IFRS in New Zealand is a step forward for reporting entities, including the Government. Although the international standards are developed with a focus on corporate entities, the ASRB has approved New Zealand equivalents to IFRS that address the reporting requirements of public benefit entities.

By applying NZ IFRS, the Government will maintain its international reputation for reporting consistently with other reporting entities – thus committing itself to meeting the same standards expected of others.

2 If NZ IFRS are the most comprehensive standards, does that mean that existing standards are inadequate?

Current New Zealand standards are similar to many of the international standards. This is because New Zealand had been actively converging to IFRS prior to the ASRB's decision in 2002 to completely transition to NZ IFRS. Where there wasn't a New Zealand version of an international standard, such as reporting of intangible assets, in many instances the international standard was used as authoritative support under current GAAP. To that extent, current New Zealand reporting requirements are robust. As with all standard setting processes, those requirements are continually reviewed and adapted to meet changing circumstances – the adoption of IFRS is a continuation of this process.

3 Is there a difference between IFRS and NZ IFRS and, if yes, what are those differences, and what does it mean for the Government's accounts?

There are some differences between IFRS and the New Zealand equivalents, but there are far more similarities.

IFRS are developed for application by profit-oriented entities - typically major corporates. Previously New Zealand standards were sector neutral; that is, the same standards were applicable both to profit-oriented entities and public benefit entities. NZ IFRS are an adaptation of IFRS which ensure that the standards applied in New

Zealand reflect factors that are unique to public benefit entities or to the New Zealand environment. For example, IFRS presumes all assets are cash generating and does not require them not to be valued above the cash that could be generated. NZ IFRS adds accounting rules for non-cash generating assets, such as the state highway network. The guidelines observed by the ASRB in adapting IFRS to New Zealand are available at www.asrb.co.nz/documents/Release82004.doc (refer paragraph 27).

The main differences between IFRS and NZ IFRS are in the areas of disclosure requirements (in some instances more disclosure is required, in some instances less) and NZ IFRS has additional guidance (often in application of the standard to public benefit entities). More information on the differences can be found at www.treasury.govt.nz/nzifrs/nzifrs-cajnz-jul05.pdf.

4 The Government reports on broadly the same basis as the corporate sector. Why is similar reporting desirable – aren't there major differences between the corporate and public sectors which would justify different accounting standards?
There are differences between the public sector and the profit-oriented sector. But there are also many similarities. For example, the Government has extensive financial asset and financial liability portfolios, owns and controls state-owned enterprises and Air New Zealand, and has significant property portfolios.

For this reason, accounting standards between public benefit entities and profit-oriented entities need only differ where necessary to provide more relevant information to users on activities in the public sector. In all other instances, the government should be held to the same standards expected of others. NZ IFRS achieves this – it provides a set of standards applicable to all entities with adaptations, where necessary, for the needs of users of public sector financial reports.

5 Has NZ IFRS replaced Generally Accepted Accounting Practice (GAAP) – will the Government's accounts no longer follow GAAP, and will GAAP disappear?
GAAP will not disappear. GAAP encompasses the standards (or rules) and concepts under which financial reports must be prepared. For the purposes of section 3 of the Financial Reporting Act 1993, compliance with GAAP means compliance with applicable reporting standards and, where no applicable standard or rule of law exists in New Zealand, accounting policies that are appropriate to the circumstances of the entity and have authoritative support within New Zealand.

Pursuant to the ASRB decision to transition to NZ IFRS, entities must now apply NZ IFRS in order to comply with GAAP.

Comparisons

1 When will numbers cease being produced under current reporting standards?
Financial statements for the year ending 30 June 2007 will be the last set produced under current standards. Budget 2007 and all financial statements from 1 July 2007 will be prepared in accordance with NZ IFRS.

2 How can financial statements prepared on an NZ IFRS basis be compared to past financial statements prepared under current accounting standards? Will historical accounts be restated on an NZ IFRS basis?
In most cases the bottom-line numbers of historical statements are directly comparable to those prepared under NZ IFRS – the impact of NZ IFRS on operating balances and cash flows is expected to be minimal relative to the size of the Government's activities;

the impact on net worth is also small relative to total net worth. Nevertheless, we will be reviewing historical data to determine what adjustments may be necessary to provide useful comparable information.

3 *What other governments prepare their financial statements on an IFRS basis? Will adopting IFRS make it harder to compare the Government's accounts to other governments which have not adopted IFRS?*

The Australian states and the Commonwealth of Australia have reported in accordance with Australian equivalents to IFRS in the 2005/06 financial year. In his most recent budget, Chancellor of the Exchequer Gordon Brown announced that the UK Government's intention is for Whole of Government Accounts to be published on an IFRS basis for the first time for the 2008/09 financial year. [The United States and Canadian governments prepare financial statements in accordance with standards set by their own national standard setting bodies - although Canada has announced a strategy to adopt IFRS, and the United States has agreed a convergence policy with IFRS. Most other governments are in the process of transitioning from cash to accrual accounts.

Substantive changes and general impacts

1 *At a practical level, a number of key indicators and items will be affected, and the format of the financial statements have changed – but what are the main substantive changes under NZ IFRS?*

In terms of the numbers, noticeable changes are few:

- Remeasurement of the ACC liability
- Remeasurement of the GSF liability and netting of GSF's assets against this liability
- Remeasurement of the guarantee provided to the National Provident Fund
- Greater use of fair values, noticeably in the initial measurement of financial assets that do not earn interest such as tax, benefits and justice receivables and student loans

NZ IFRS also provides more detailed rules and disclosures which influence how transactions are considered and reported (e.g. reporting of concessionary loans) and, in areas such as financial instruments, requires these disclosures to reflect the governing entity's management practices (e.g. for external reporting to more closely reflect the information used for internal reporting). These are important, but less evident, changes as a result of adopting NZ IFRS.

2 *How will changes to asset and liability valuations affect revenue and expenses?*

On transition to NZ IFRS, they won't. Changes to the value of assets and liabilities as a result of adopting NZ IFRS (including the GSF, ACC and NPF liability remeasurements) do not affect revenue, expenses or cash flows. All such transition changes are made against net worth in the balance sheet. Going forward, there will be some consequential changes to revenue and expenses, but these changes will have a relatively small impact on the bottom-line.

3 *What is the impact for depreciation?*

Little impact is expected. The current New Zealand standard for reporting plant, property and equipment and related depreciation is almost identical to NZ IFRS for public benefit entities. The only NZ IFRS impact expected to arise is in relation to the reclassification of buildings between those that are used for normal operations (and are therefore depreciated) and those that are held-for-sale or are investment properties (and are therefore revalued annually rather than depreciated).

4 *Will there be any changes to Government accounting policies as a result of NZ IFRS?*

Yes. Accounting policies will change to reflect NZ IFRS terminology (e.g. financial instruments have certain designations), and will be more comprehensive (longer) to reflect the greater level of detail and disclosures required under NZ IFRS. Draft NZ IFRS policies are available at www.treasury.govt.nz/nzifrs/nzifrs-sapfsgnz-30jun06.pdf. These policies will be updated to include forecasting policies and will be available on Treasury's website with the release of the 2007 Budget Economic and Fiscal Update .

5 *How have forecasting policies changed under NZ IFRS?*

Forecasting policies have been adapted for NZ IFRS, but are largely unchanged from those currently used. Guidance on government forecasting policies under NZ IFRS is available at www.treasury.govt.nz/circulars/default.asp#2007-4. NZ IFRS forecasting policies will be available on Treasury's website with the release of the 2007 Budget Economic and Fiscal Update.

6 *NZ IFRS means greater use of fair values – how is fair value forecast?*

Typically changes to fair values are not forecast. That is, the value of an asset or liability at the date of the forecast is assumed not to change for market movements. To forecast fair value would be to assume that future market movements can be predicted.

The exception is the government's financial asset portfolios, such as those held by ACC, EQC and the New Zealand Superannuation Fund (NZS Fund). Forecasts on these portfolios (as opposed to individual assets within these portfolios) include an expected rate of return. This approach is a better forecasting assumption given the long-term, diversified nature of these portfolios and the analysis underlying calculation of these expected rates of return.

7 *The forecasts will show derivatives declining over the forecast period – why?*

Because derivatives are measured at fair value and future fair values are not forecast, new derivatives are assumed to have a zero fair value (that is, both sides of the derivative net-off). So, as existing derivatives mature (which will reduce the balance of derivatives but increase the balance of other assets or liabilities) and are replaced by new derivatives (which have a forecast value of zero) the balance of derivatives will decline. More guidance is available at www.treasury.govt.nz/circulars/default.asp#2007-4.

8 *NZ IFRS means more comprehensive reporting of financial instruments, such as derivatives. Does that mean derivatives are "off balance sheet" under current accounting standards?*

By being more comprehensive, NZ IFRS provides greater consistency in approach to reporting transactions and balances, such as derivatives, within and across entities. Many derivatives are currently reported on the government's balance sheet, but not all. However, current accounting standards require disclosures in the notes to the accounts for all financial instruments (both on and off balance sheet).

9 Are cash flows affected by adopting NZ IFRS?

NZ IFRS does not affect physical cash flows. But it does change what can be classified as 'cash and cash equivalents'. For example, term deposits with a maturity up to 12 months that can be readily converted into cash are currently included in cash, whereas under NZ IFRS cash includes deposits of up to three months' maturity only. This change in definition will result in small differences between NZ IFRS and current standards. Such differences will show up in:

- the value of cash reported in the balance sheet (this is simply a reclassification between cash and advances with no impact on net worth)
- net cash flows in the cash flow statement. This is because the cash flow statement will include the sale and purchase (or establishment and maturity) of all deposits with a maturity originally greater than three months. Such flows did not previously need to be reported, as they were already captured in the cash balance in the balance sheet

10 The story for the Government's financial statements appears to be largely business as usual with regard to the "bottom-lines" – this is different to what some corporates say for their business. Why?

Significant issues identified by some reporting entities are not applicable to the Government's financial statements or are not as material given the size of the Government's financial statements. For example,

- NZ IFRS includes a fundamentally different standard for recognising and reporting tax expenses and tax liabilities which is not applicable to the Government as tax collector.
- The Government has reported its defined benefit liabilities for the Government Superannuation Fund for a number of years. For some entities these liabilities have been "off-balance sheet" but will be brought onto the balance sheet under NZ IFRS.
- Fair valuing agricultural assets as required by NZ IFRS can have a significant effect on the financial statements of entities involved in that sector. However, these comprise less than 1% of the Government's asset portfolio.

Changes to fiscal indicators (impacts and characterisation)

1. Will there be more volatility in the operating balance – and if so, why?

It is unclear whether there will be more volatility in the operating balance, although it is expected there may be greater volatility in individual revenue or expense items.

Volatility typically arises from fair value movements, because fair values are not forecasted and are typically less able to be controlled in the short-term. Volatility also arises where related items are valued on a different basis (sometimes called accounting mis-match) - such as valuing a financial asset at fair value while valuing a related liability at amortised cost. Although there is greater use of fair values under NZ IFRS, NZ IFRS may also reduce the extent of accounting mis-matches.

2. Government sovereign-issued debt (GSID) and net debt have risen under NZ IFRS. Will the Government be paying more in interest?

No. NZ IFRS does not change the Government's debt obligations. In fact, the primary reason for GSID and net debt increasing is because these measures now capture reported accrued interest, whereas previously accrued interest was included in other 'payables' in the balance sheet (payables are excluded from the GSID calculation).

3. Net worth has risen by $1.5 billion under NZ IFRS. Does that mean there is more money available for spending?

No. Transitioning to NZ IFRS does not physical cash flows. The increase in net worth is the net effect of remeasuring assets and liabilities, most of which are very long-term in nature and are sufficiently large that small changes in key assumptions can be material. Understanding the reasons for the changes in net worth and how that net worth is comprised (i.e. nature of assets and liabilities that contribute to net worth) does, however, help users to assess the robustness of the government's balance sheet to meet current and future obligations.

4. What happened to OBERAC? What's replaced it, and how do we find it?

The combination of NZ IFRS requirements and proposed changes to the presentation of the operating statement has resulted in a new line in the operating statement called 'Operating Balance before Gains and Losses'. Because this is similar to the OBERAC concept, it was decided that it would replace OBERAC.

5. How is Operating Balance before Gains and Losses different to OBERAC?

The operating balance before gains and losses differs from the OBERAC in three ways:

- It will exclude *all* items reported as gains and losses (the OBERAC materiality cut-off was formally set at $100 million)
- It will exclude any items reported as gains and losses regardless of whether they arise from market activities or government policy decisions. Gains and losses from the latter occur infrequently, and are captured in the operating balance indicator.
- Under NZ IFRS, changes that arise from changing accounting policies will typically require prior periods to be restated. As a result, under NZ IFRS there would have been no (or very few) accounting change adjustments to the operating balance (i.e. the 'AC' in OBERAC).

6. Why are gains and losses separated from revenue and expenses?

Separately reporting gains and losses provides users with a fuller set of information (revenues and expenses *and* gains and losses) to evaluate performance. It should enable users to better identify and assess:

- the cause of variances between actual results and forecasts, as variances from gains/losses (which are typically not forecast) will be readily evident
- the impact and volatility of gains and losses on results
- the relationship between gains and losses e.g. gains and losses in derivatives often have a close relationship with gains or losses in other financial instruments.

It should also reduce the 'noise' that can arise from changes in fair value of items such as share investments - being income (gains) one-month and expense (losses) the next.

This approach builds on NZ IFRS requirements to separately identify certain gains, such as gains on sale of property, from revenue even though both revenue and gains are forms of income.

7. Is the Operating Balance before Gains and Losses excluding New Zealand Superannuation Fund (NZSF) returns the residual cash available for the Government to spend?

No. Residual cash is a <u>cash</u> measure applicable to the <u>core Crown</u> only. That is, it is the net of core Crown operating cash flows (e.g. tax receipts, benefit payments) plus specified core Crown investments (e.g. purchase of physical assets, advances to SOEs, contributions to the NZS Fund).

In contrast, the Operating balance before gains and losses is an <u>accrual</u> measure that captures the activities of the <u>total Crown</u> (SOEs, Crown entities, departments). Given that the NZS Fund is a ring-fenced, pre-funding mechanism for meeting future fiscal pressures, it is useful to look at the operating balance before gains and losses with and without NZS Fund activity.

The relationship between operating balances before gains and losses (or, to date, OBERAC) and residual cash is shown in all our financial reporting – refer to Table 3 in the Crown's monthly financial statements for an example.

8. *The Government has, in the past, targeted OBERAC excluding NZS Fund returns – under NZ IFRS, will it target the Operating Balance before Gains and Losses excluding NZS Fund returns?*

No single indicator is sufficient for measuring performance, hence why there is a range of fiscal indicators that the Government targets. This will include the *Operating Balance before Gains and Losses excluding NZS Fund returns*. It is useful to have indicators that include and exclude the NZS Fund given the role of the Fund in fiscal policy; that is, it is a pre-funding mechanism with ring-fenced assets. Furthermore, as the Fund will grow significantly over time, reporting it separately will ensure other areas of government activity are not obscured by the Fund's performance.

9. *What other changes to the fiscal indicators are there?*

There are two changes to fiscal indicators:

a. introduction of operating balance before gains and losses to replace OBERAC - discussed above
b. 'Core Crown revenue excluding NZS Fund returns' and 'NZS Fund returns' indicators will be used in lieu of the single 'Core Crown revenue' indicator currently used. Having the two indicators allows discrete analysis of these two primary indicators of fiscal policy.

10. *Where the fiscal indicators haven't been renamed, are they essentially the same number as before?*

Yes. Note, however, that:

- OBERAC and operating balance before gains and losses have slightly different compositions (refer to question 5 above).
- GSID and Net core Crown debt include accrued interest under NZ IFRS
- Core Crown expenses and core Crown revenue indicators will exclude losses and gains.

The accompanying presentation provided to media/analysts on 9 May 2007 included a table that shows the small changes to fiscal indicator numbers for results to December 2006.

Particular impacts (ACC, GSF, etc.)

1. *The value of the Government's ACC liability has increased by $1.6 billion under NZ IFRS, on the basis of a risk margin and liability adequacy test. Does that mean it is riskier than previously thought?*

No. There is no change to the risk profile or policies underpinning the ACC liability.

The current measurement represents a mid-point estimate – that is, equal chance of actual payouts being greater than or less than the estimate. To that extent, it represents the most likely outcome.

Introducing a risk margin and liability adequacy test, as required by NZ IFRS, does not change the relative risk of ACC's activities. Rather, it simply changes how this risk is measured – rather than taking a mid-point approach, a more conservative estimate is produced. The new liability value means there is increased likelihood that actual payouts will be less than the reported liability.

2. *Will ACC levies rise as a result – and if not, why not, if the liability is considered higher risk?*

No. Levy loadings of 10% on fully funded claims and 15% on residual (i.e. pre 1 July 1999) claims were used in the 2006/07 levy setting process. Last year, when calculating the 2007/08 levies, ACC included a "risk margin" of 11% in line with the level of risk margin deemed appropriate under IFRS4. At the same time, the levy loadings were reduced to 0% on fully funded claims and 5% on residual claims. Thus, the additional risk margin was almost entirely offset by a reduction in the levy loadings with a negligible effect on levy rates.

3. *What is the difference between the risk margin and the liability adequacy test for ACC's liability? What has been the impact of each of these on the liability?*

The risk margin is the additional amount added to the liability of <u>outstanding</u> claims (i.e. those that are already known). Including a risk margin has increased the reported liability by $1.4 billion.

The liability adequacy test relates to future claims for which levies have already been recognised as unearned in the balance sheet. Levies are typically paid in advance. The liability adequacy test assesses whether these levies paid in advance (which are unearned) are likely to be sufficient to cover the cost of claims that will arise for the period ahead. . For ACC, the liability adequacy test resulted in an increase to the total ACC liability of $0.2 billion.

4. *Does this mean that current levies aren't covering their future costs? Who is going to pick up the difference – the Government, or will levies need to increase in future?*

Levies are set to ensure that costs are recovered over time. When ACC reserves build up from ACC's financial asset transactions, these reserves are drawn on to fund the liability. This is what the liability adequacy test reveals – levies are not covering future costs because ACC is currently drawing on the financial reserves it has built up to fund the difference. NZ IFRS does not change this approach to setting levies.

5. *The liability associated with the Government Superannuation Fund (GSF) is lower under NZ IFRS – does that mean the Government owes less than it thought?*

Under NZ IFRS, measuring the Crown's obligations to GSF on a pay-as-you-go basis reveals that the liability is less than originally thought, as there are fewer investment tax obligations.

Historically, the Crown financial statements have recorded the total (gross) GSF pension liability in the Statement of Financial Position, with the GSF assets being reflected separately in that same statement. Under NZ IFRS, two changes have been made to reporting:

a. a netting of GSF's assets against the total (gross) GSF pension liability in the Statement of Financial Position

b. measuring the GSF liability on the basis that the Crown meets its obligations on a pay-as-you-go basis (rather than recording the amount required to be invested today to fully fund future Crown contributions to GSF).

   Measuring the Crown's obligations on this basis means that future investment tax obligations of GSF to the Crown can be offset against the Crown's liability calculated after the netting off of the GSF assets (as per a. above).

The above two changes do not alter in any way the Crown's obligations to GSF and its members.

6. How will GSF members be affected – will the Government's contributions to the GSF change as a result?

The obligations to GSF's members are underwritten by the Crown. These obligations are unaffected by the remeasurement of the liability. The only change has been to accounting standards, which simply specify how the GSF obligations are reflected in financial statements – the changes to reporting do not impact on the obligations themselves.

Changes to formats

1. Under NZ IFRS, gains and losses are reported separately from revenue and expenses, and there is an "other gains/losses" section. What is an "other gain/loss"?

NZ IFRS requires some gains, such as gain on sale of property, to be separately identified from revenue. It also requires more gains and losses, such as those on derivatives and agricultural assets, to be reported in the operating statement. However, there is little other guidance on what is a gain or loss (as opposed to revenue) and how these could or should be presented in the operating statement.

The approach adopted for the Government's financial statements is to capture within this section those gains and losses that arise from:

- changes in financial instruments whose fair value movements (interest movements are reported under interest revenue or finance cost) are reported in the operating statement
- actuarial gains or losses (e.g. actuarial gains and losses on the GSF liability)
- market (or external) factors that change the value of provisions, such as price or exchange rate changes.

The final composition of this section will be fine-tuned in consultation with the auditors and mindful that changes to the presentation of the operating balance are being actively considered by the International Accounting Standards Board.

2. *Are there benefits from separately identifying gains and losses from revenue and expenses?*

Yes. This separation should enable users to better identify and assess:

- future cash flows
- the causes of variances between actual results and forecasts, as variances from gains/losses (which are typically not forecast) will be readily evident
- the impact and volatility of gains and losses on results
- the relationship between gains and losses - e.g. gains and losses in derivatives often have a close relationship with gains or losses in other financial instruments. Further, if they weren't separately reported then gains from a transaction in one period would be reported alongside revenue while losses for the same transaction in the subsequent period would be reported with other expenses – making it difficult for users to track underlying revenues/expenses over time.

3. *What impact will that have on revenue and expenses in the financial statements?*

The most likely effect is on revenue, which will be lower because it will no longer include fair value movements on financial assets. How much is allocated to gains and losses in any reporting period rather than revenue or expenses depends on market movements during that period. However, users can evaluate total income or total expenses/losses by simply adding net gains or net losses to revenue and expenses respectively.

4. *Will there be fewer disclosures in the financial statements?*

There will be considerably more disclosures in the financial statements. In fact, one of the challenges with adopting NZ IFRS is how to meet all the additional disclosure requirements while keeping the financial statements user friendly. Any suggestions on how to make the statements more useful are welcome – the Treasury continually tries to improve the usefulness of its reporting.

Budget 2007 and fiscal strategy

1. *Budget 2007 is the first to be prepared on an NZ IFRS basis. Has that affected funding decisions?*

No.

2. *Will there be any changes to appropriations as a result of NZ IFRS?*

Expenses that require appropriation are almost identical between current standards and NZ IFRS. As a result, we are aware of only a few instances where there may be differences in appropriation requirements between current standards and NZ IFRS.

3. *How will NZ IFRS affect the interpretation of the fiscal strategy?*

Very little. The impact of NZ IFRS on the bottom-line is relatively small – less than 1% of GDP for most fiscal indicators.

Other

1. *The numbers presented are provisional. How likely are they to change?*

The numbers will change as progress towards full implementation and audit on the financial statements for the year ending 30 June 2008, particularly if there are any changes to accounting standards during that time. However, such changes are expected to have minimal on reported results.

2. When will the numbers be audited?

The opening balance sheet constructed as at 1 July 2006 has been reviewed by auditors. A first full audit opinion covering this balance sheet and financial statements prepared under NZ IFRS for the year ending 30 June 2008 will be completed around September/October 2008.

3. To the extent the December half-year results have been used for illustration, can they simply been doubled to get a full-year picture?

No. Results are affected by market activity and seasonal variations. There is no expectation that market movements such as share prices, interest rates and exchange rates for the remaining six months will be identical to those to December.