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GUIDANCE ON FORECASTING POLICIES FINANCIAL INSTRUMENTS UNDER NZ IFRS

This circular details NZ IFRS forecasting policies for financial instruments under NZ IFRS and reiterates key forecasting policies for other transactions, which are unchanged from current GAAP. These policies apply to 5-year NZ IFRS forecasts provided for Budget 2007 and beyond.

This circular will be of most interest to entities that fair value financial instruments, have financial instruments that have non-market elements (e.g. low or no interest rates with long maturities) and/or have derivatives. For most other entities there will be little change, if any, to current forecasting practice.

The structure of the circular is:

- General messages
- Forecasting policies for financial instruments
- Forecasting policies for non-financial instruments

Annexed to this circular is additional guidance on:

- Filling out CFISnet schedules for the 5-year forecasts
- Applying the financial instrument policies

General messages

- NZ IFRS forecasting policies are largely unchanged from current GAAP policies.
- Forecasts for derivatives should only include those that exist at the forecast reference date¹, and then only to their maturity. That is, by the end of the

¹ Forecast reference date for Budget 2007 is 28 February 2007

forecast period only those derivatives existing at the forecast reference date with a maturity beyond 2010/11 should be recognised in the financial statements.

- Future derivative activity should not be included in forecasts. This is because fair value forecasts of future derivatives is zero due to forecast exchange rates being fixed at the rate at the forecast reference date, as are interest rate curves and other assumptions (e.g. electricity pricing curves) affecting the value of derivatives.
- Forecasts of instruments that have non-market elements (e.g. low or no interest rates with long maturities such as student loans or social benefit receivables) should include the forecast write-down to fair value on initial recognition and the revenue from the effective interest unwind.
- Entities should confirm material forecast inter-entity balances (i.e. over \$10m) with the counter-party (as they are required to do currently). It is critical that both sides to a material inter-entity transaction have the same basis for their forecasts (any material differences in balances submitted through CFISnet will be identified through the consolidation process and will need to be rectified immediately).
- Entities should use the text column in the DataLoad to identify the other entity of inter-entity balances.
- Review forecasts for the purchase of physical assets to ensure they show a realistic profile across all forecast years (analysis of prior year forecasts shows forecasts for purchases of such are typically below actual results).
- For departments, forecasts for appropriations and capital expenditure for the current year-end should be based on expected results rather than appropriation limits. Typically, expenditure forecasts should be less than approved appropriation levels (which are maximum levels).

Financial instrument forecasting policies (to be read in conjunction with NZ IFRS accounting policies)

- Forecasts use the exchange rates, interest rate curves and electricity pricing curves prevailing at the forecast reference date. As a consequence, no additional realised or unrealised foreign exchange gains or losses are forecast for the entire forecast period
- Interest income and interest expense is recognised using the effective interest rate method (which in most instances will equal the coupon rate for future instruments)
- Gains and losses reflect long run rate of return assumptions appropriate to the forecast portfolio mix, after adjusting for interest income and interest expense (recognised separately using the effective interest rate method)
- Forecast sales and purchases of bonds and other liquid instruments are assumed to be issued at par value, with no discounts or premiums forecasted.

- Only the value of derivatives as at the forecast reference date may be realised – no additional realised or unrealised derivative gains or losses are recognised over the forecast period. Forward margins on forward foreign-exchange contracts existing at the start of the forecast period are amortised over the period of the contract on a straight line basis.
- All financial assets and financial liabilities held at the forecast reference date are assumed to be held until they mature.

Forecasting policies for non-financial instruments

The Crown's NZ IFRS accounting policies provide the basis for recognising, measuring and disclosing actual and forecast financial information. These are available at www.treasury.govt.nz/nzifrs/nzifrs-sapfsgnz-30jun06.pdf.

The following forecasting policies, which are unchanged from current GAAP, should be read in conjunction with these NZ IFRS accounting policies:

- Forecasts of the value of property, plant and equipment (including state highways and rail infrastructure), investment properties and non-financial assets held-for-sale for the current year² should use the valuations as recorded in the Financial Statements of the Government for the prior year³ and any additional valuations that have occurred up to the forecast reference date.
- The value of property, plant and equipment), investment properties and non-financial assets held-for-sale is forecast using the same valuation as the 30 June 2007 forecast. As a consequence, no further realised or unrealised gains or losses are forecast for the entire forecast period.
- Forecast operating lease revenues and expenses are recognised in a systematic manner over the forecast term of the lease.
- The cost of forecast leasehold improvements is capitalised and amortised over the forecast unexpired period of the lease or the estimated useful life of the improvements, whichever is shorter.

Hugh Packer
for Secretary to the Treasury

² Current year forecasts for Budget 2007 are for the year ending 30 June 2007

³ Prior year valuations for Budget 2007 are those as at 30 June 2006

Annex One: Filling out CFISnet schedules

In most respects, reporting forecasts is similar to reporting actuals. Points to emphasise are:

- Refer to the dataload dictionary and the FAQ in CFISnet Help if in doubt where to post lines. If still in doubt, contact Treasury (contact details are above)
- Use text lines to explain material balances and/or identify the other entity to inter-entity transactions. Use schedule 1:50:1 (or 1:70:1 for Crown activity) if there are many different material revenue and expense transactions with different entities
- The distinction between current and non-current in the balance sheet (schedule 1:51:0) is not material for forecasting purposes. Therefore, the focus should be on accurately forecasting the total value of each item rather than its current/non-current status. This is a distinguishing feature of forecasts only – for actual reporting the current/non-current distinction is important for audit purposes.
- The allocation of revenues/expenses, assets/liabilities and cash flows across the different groups (SOE, Crown entity and department segments and 3rd parties) does affect consolidated results, so please ensure the correct lines are used
- Confirm material inter-entity balances and values with the other entity. Mismatches are very transparent at the consolidated level and do need to be corrected
- If you hold government stock or have material inter-entity loans or derivatives, complete the financial instrument spreadsheet designed for Budget 2007. This spreadsheet is available on CFISnet's Homepage (it is the monthly schedule updated to include forecast periods). This must be uploaded at the same time as the CFISnet schedules.

Annex two: Forecasting financial instruments - application guidance

The following guidance re-emphasises the measurement approaches required under NZ IFRS and related forecasting approaches. Feedback for improving this guidance is welcome so that it can be made a more valuable tool for entities.

Type of Instrument	Designation	Measurement basis	Forecast approach
Financial Assets	Loans and receivables	Initial recognition at fair value, subsequently at amortised cost	<p>For short-term trade debtor portfolios, no impacts on operating balance (i.e. no change to current practice). Balance sheet will equal face value.</p> <p>Where interest is charged or where time value of money is material (e.g. loans issued at non-market rates or long-dated receivables not earning interest), the operating statement will be affected by unwind of the effective interest rate and, where time-value of money is material, write-down on initial recognition. Balance sheet value will change in line with interest rate unwind and fair value write-down.</p>
	Available-for-Sale (AFS)	Initial and subsequent recognition at fair value. Subsequent recognition applies the effective interest rate unwind while any residual fair value goes to the AFS reserve in Equity	<p>As above for loans and receivables, interest is recognised using the effective interest rate method.</p> <p>Forecasts should only assume changes in residual fair values where long-run rate of return assumptions differ to the effective interest unwind. For entities with relatively small portfolios, no future fair value movements will be recognised i.e. the AFS equity reserve will be unchanged until maturity. On maturity, any balance in the AFS equity reserve goes to the operating statement.</p>
	Fair value through profit and loss (FVPL) and Held for trading (HFT) – excluding derivatives	Initial and subsequent recognition at fair value with all changes in value going through the operating statement	Forecasts should be based on long-run rate of return assumptions. The interest component of the instrument's value is calculated using the effective interest method. This is reported separately from other gains/losses. The sum of the interest component and other gains/losses should be consistent with the long-run rate of return assumptions.
	Derivatives in gain	As per HFT instruments	<p>Only the value of derivatives as at the forecast reference date may be realised – no additional realised or unrealised derivative gains or losses are recognised over the forecast period.</p> <p>Forward margins on forward foreign-exchange contracts existing at the</p>

			<p>start of the forecast period are amortised over the period of the contract on a straight line basis.</p> <p>Derivatives that exist as at the forecast reference date will be reduced to nil by maturity. Forecasts do not include new derivative activity.</p> <p>In practice, entities are likely to offset reductions in derivative in gains balances with increases in other financial assets (or decreases in financial liabilities where appropriate)</p>
Financial Liabilities	Amortised cost	As per Loans and Receivables designation above	As per Loans and Receivables designation above
	Fair value through profit and loss (FVPL) and Held for trading (HFT)	As per Financial Assets designated at FVPL and HFT above	As per Financial Assets designated at FVPL and HFT above
	Derivatives in loss	As per derivatives in gain above	<p>As per derivatives in gain above.</p> <p>In practice, entities are likely to offset reductions in derivative in losses balances with increases in other financial liabilities (or decreases in financial assets where appropriate)</p>
Hedge accounted Instruments	Cash flow Hedge		<p>Only cash flow hedges in place as at the forecast reference date are included in forecasts (refer to discussion on derivatives as to why future derivatives are not forecast).</p> <p>Forecasts assume 100% hedge effectiveness going forward. Balances in cash flow hedge reserves go to the operating statement or are capitalised in the cost of assets in line with related forecast flows of the hedged instrument or transaction.</p>
	Fair Value Hedge		<p>Only fair value hedges in place as at the forecast reference date are forecast.</p> <p>Forecasts should assume 100% hedge effectiveness going forward.</p>
	Investment in Foreign Operation Hedge		As per cash flow hedge accounting above