15 August 2005

NZ IFRS 1 OPTIONAL EXEMPTION POLICIES

This note:

- identifies the optional exemptions available in NZ IFRS 1 on transition and whether the decision to adopt a particular exemption is to be taken at the consolidated (Crown) level or at the individual entity level; and

- provides further detail as to why a decision is required at the Crown or entity level where the answer may not be immediately obvious

This note draws on KPMG's report to Treasury on Implementation of NZ IFRS for the financial statements of the Government (FSG). The relevant section of the report is provided in attachment one.

This note reflects views as at August 2005. As implementation progresses some of these views may be revisited. Any subsequent changes will be reflected in the statement of NZ IFRS accounting policies for the Government's financial statements.

Choosing between options

In choosing which exemptions to apply and whether the decision is taken at Crown or entity level, the approach being applied is:

- Existing Crown policies are continued under NZ IFRS unless it is no longer permitted or if an alternative policy will provide relevant and more reliable information; and

- Policies are left to entities where practicable.

NZ IFRS 1 OPTIONAL EXEMPTIONS SUMMARY

Option	Decision level	Comment	Reference
Restatement of business combinations	Crown	Restatement not permitted	NZ IFRS1-15 & B2(g)
Assets and liabilities of subsidiaries, JVs and associations where adoption dates differ	Crown	Early adopters are to apply Crown policies for NZ IFRS as promulgated at the time of their reporting	NZ IFRS1-25
Recognition of cumulative actuarial gains/losses in respect of employee benefits	Crown	All movements in the resulting liability are reported in the statement of financial performance.	NZ IFRS1-20
Write-off of cumulative translation differences at the date of transition	Crown	Although a couple of entities have cumulative exchange differences, these are not recognised in the GFS. Further work will is required with these entities to assess whether a GFS policy is required.	NZ IFRS1-22
Fair value or revaluation as deemed cost of items of PPE	Entity	Treasury is to be notified where entities intend using deemed cost for assets that are, and will continue to be, fair valued. We are reviewing whether application of deemed cost is required for some of these fair valued assets held within the core Crown segment (i.e. departments and Crown balance sheet). Otherwise, entities can choose whether to apply deemed cost.	NZ IFRS1-16
Application of NZ IFRS 4 Insurance Contracts exemptions	Entity	Entities can determine whether the exemptions are relevant and whether they are applied. If it is revealed there are a number of similar insurance contracts across entities that are material to the GFS then further investigation of this issue will be undertaken.	NZ IFRS1-25D
Recognition of changes in existing decommissioning/restoration liabilities	Entity	Entities can choose whether to apply this exemption according to their reporting needs	NZ IFRS1-25E
Application of transitional provisions in IFRIC 4 Determining whether an arrangement contains a lease	Entity	Entities can choose whether to apply this exemption according to their reporting needs	NZ IFRS1-25F
Compound financial instruments	Entity	Affects only one entity. A GFS policy will be developed in consultation with the entity.	IFRS1-23
Retrospective application of IFRS2 Share-based payments	Entity	Affects only one entity. A GFS policy will be developed in consultation with the entity.	IFRS1-25B

DISCUSSION ON SPECIFIC POLICIES

Restatement of business combinations

Policy: restatement not permitted

A decision by one entity to restate business combinations when reporting to the Crown impacts other entities under NZ IFRS 1, therefore a Crown wide policy is required. There are potentially large costs in identifying all business combinations across the Crown reporting entity, determining the pros/cons of restatement at the entity and GFS level, and ensuing consistent application of the exemption across all entities. The benefits of restatement are not evident. Accordingly, restatement is not permitted.

Assets and liabilities of subsidiaries, JVs and associations where adoption dates differ

Policy: entities adopting earlier than the Crown are to apply GFS policies, as promulgated at that time

No entities are adopting after the Crown so the option exemption under NZ IFRS 1 does not apply. However, we know that schools, TEIs and one other entity are adopting NZ IFRS before the Crown. NZ IFRS 1 requires the GFS to measure the assets and liabilities of these early adopters at the values they use in their NZ IFRS statements. Accordingly, early adopters need to apply the Crown's NZ IFRS policies (as promulgated at that time) to ensure consistency in GFS policies under NZ IFRS.

Note that entities adopting earlier than the Crown will need to continue reporting current GAAP information to Treasury until 1 July 2007.

Recognition of cumulative actuarial gains/losses in respect of employee benefits

Policy: GFS policy is to not use the corridor approach. All movements are to go through the statement of financial performance.

This approach rolls-over the current policy applied to FSG, the only defined benefit retirement plan currently reported in the GFS, with a net liability exceeding $10bn.

Some entities have indicated that they may also have defined benefit retirement plans. They cannot use the corridor approach when reporting to the Crown. However, entities also have the option of posting actuarial gains/losses to equity. Treasury is looking at the DataLoad design to determine how this information can be captured without requiring entities to report on a different basis to match the GFS policy.

Fair value or revaluation as deemed cost of items of PPE

Policy: deemed cost may be used, but entities need to advise Treasury if they will use it where assets are currently revalued and will continue to be revalued under NZ IFRS.

Any item of PPE can apply the deemed cost exemption. If deemed cost is used, entities retain the choice going forward as to whether to measure at cost or revalue.

The revaluation reserves and carrying values are:

June 2004	Revaluation Reserve	Net Carrying Value
Land and Buildings (fair value)	12,873	26,755
Electricity distribution network (cost)		1,958
Electricity generation assets (fair value)		4,499
Aircraft (fair value)		1,149
State highways (fair value)	3,266	13,082
Specialist Military Equipment (fair value)	5	2,298
Other plant and equipment (cost)		3,261
Other Assets - largely heritage assets of DoC, Archives, Nat Library, Te Papa (fair value)	2,016	4,938
Total		**57,940**

The impact of applying deemed cost varies according to how the asset is currently measured and how it will be measured under IFRS:

Current Measurement	NZ IFRS Measurement	Impact of applying deemed cost exemption
Cost	Cost	If fair value > carrying amount, deemed cost will provide a one-off increase to net asset base. This will increase depreciation on depreciable assets and, where applicable, capital charge. Opposite effect if fair value < carrying amount
	Fair Value	Would enable any revaluation gain on transition to go direct to equity rather than revaluation reserve.
Fair Value	Cost	The option is useful if cost is otherwise difficult to determine. It would clear out amount in revaluation reserve but this has little impact as the reserve would not be available for future use under cost measurement.
	Fair Value	Clears out any amount in revaluation reserve which may help entities that have to revalue asset-by-asset going forward. Future devaluations more likely to hit profit if revaluation reserve balance wiped out.

Looking at these scenarios:

- Cost-to-cost: plant and equipment and electricity distribution assets (Transpower) are both currently at cost and will remain at cost in future :
    - plant and equipment comprise a high number of relatively low value items such as vehicles, computers and furniture and fittings, so decisions by individual entities to apply deemed cost should not be material for the FGS.
    - electricity distribution assets are moving to cost in June 2005, using most recent valuation as deemed cost at that date. There should be little difference between the deemed cost applied in June 2005 and the amount that could be used as deemed cost in 2006.

- Cost-to-fair value: there is no asset class that will move from cost to fair value measurement on transition so this scenario is not relevant (electricity generation assets move from cost to fair value in June 2005).

- Fair value-to-cost: there are no asset classes that will move from fair value to cost measurement on transition.

- Fair value-to-fair value: this applies to all other asset classes. Experience by other entities indicates deemed cost will not be used in these circumstances. Nevertheless, if entities want to use deemed cost for such asset classes then Treasury needs to be notified so that we can assess how this will impact on revaluation reserves reported in the FSG. For some fair valued assets held in the core Crown segment, postings to/from the relevant revaluation reserve have been required at the consolidated level. Treasury is reviewing this approach, which may necessitate requiring deemed cost to be applied for such assets on transition. Treasury will notify any affected departments when this review is completed.

Attachment One: NZ IFRS 1 policy choices

Findings and rationale

Exemptions that could be relevant to the CFS[1]

The following exemptions are considered relevant to the CFS:

- Restatement of business combinations.
- Fair value or revaluation as deemed cost for items of property, plant ad equipment.
- Assets and liabilities of subsidiaries, associates and joint ventures.
- Designation of previously recognised financial instruments – covered in detail in section 5.
- Insurance contracts.
- Decommissioning liabilities included in the cost of property, plant and equipment.
- Applying the transitional provisions of IFRIC 4.

Restatement of business combinations

It is inevitable that entities that make up the CFS have acquired new businesses or interests in entities. It is therefore appropriate to consider the accounting under NZIFRS for business combinations that occurred before the date of transition.

This exemption allows entities to:

- Restate all these business combinations; or

[1] KPMG's report uses the term Crown financial statements (CFS) which is equivalent to the term Government's financial statements (GFS) used earlier in this note

- Restate all business combinations after a particular date; or
- Not restate any business combinations prior to transition.

Advantages	Disadvantages
• Previous amortisation of goodwill is reversed, resulting in a higher asset base. • More accurately reflect intangible assets acquired in a business combination. • Less onerous impairment testing where all goodwill is eliminated through separately recognising assets and liabilities previously subsumed in goodwill.	• Goodwill must be tested for impairment on an annual basis regardless of there being an indication of impairment – potentially complex and costly. • It is sometimes complex to restate business combinations, and entities may not necessarily have the required information at hand. • Adjustments will be required to certain assets and liabilities that do not comply with NZIFRS requirements regardless of the above-mentioned exemption. • All business combinations of the reporting entity (in this case the consolidated CFS) after the chosen date have to be restated resulting in significant costs for entities. • Reopening a combination and replacing goodwill with identifiable intangibles will usually result in an amortisation charge in the future (whereas goodwill will not be amortised).

Experience

In our experience companies are generally not restating business combinations that occurred prior to the date of transition, principally as the cost of the exercise would outweigh the benefits. In limited instances where an individual transaction could have a profound impact on the group financial statements, application was considered, but normally rejected since it would require all entities within the group to restate business combinations after that particular date. Although individual entities could adopt this exemption for their separate financial statements, it would have to be reversed on consolidation each year into perpetuity.

Should exemption be considered initially at a Crown or individual entity level?

This exemption should be considered at a Crown level as the decision binds all entitles within the CFS.

Fair value or revaluation as deemed cost of items of property, plant and equipment

NZIFRS specifies how the cost of items of property plant and equipment should be determined. The CFS includes assets for which the information to determine this “true NZIFRS cost” might not be readily available, or that currently are not included in the balance sheet of individual entities.

This exemption allows entities to measure an item of property, plant and equipment at its fair value and to use that fair value as deemed cost under NZIFRS. This fair value could be determined at date of transition or a previous revaluation to fair value could be used. This exemption also extends to intangible assets, where an active market for the intangible asset exists.

Advantages	Disadvantages
• Avoids cost of determining actual costs of assets where the information is not readily available. • Assets will be recorded at a higher base resulting in an increased net asset position. This is of particular relevance where the asset was originally acquired for nominal value. • This one-off valuation would not require an entity to continue to revalue the items or class to which the items belong. • Allows elimination of the existing revaluation reserve and therefore the revaluation reserve would not need to be analysed by asset or class of assets (depending on the accounting policy chosen). • Revaluing land has the benefit of a higher asset value without any ongoing effect on profit (i.e. depreciation). • May benefit achievement of KPIs. • Recognise the value in specialist assets.	• Depreciable assets are recorded at a higher base overall, but with a higher depreciation charge and an increase (for taxable entities) in deferred tax liability (which is not an issue at the level of the CFS). • If choose to continue with a revaluation policy, future decrements would impact profit as there will be no revaluation reserve against which they could be offset.

From May 2005 KPMG report to the Treasury on Implementation of NZ IFRS for the Crown Financial Statements

Experience

In some instances, where adoption results in additional liabilities being recognised, which put debt covenants at risk, entities are choosing fair value as deemed cost at date of transition, to increase their asset base. The downside of this (although not relevant to the CFS), is the recognition of deferred tax on the increase in deemed cost.

In our experience, New Zealand entities are generally not choosing the deemed cost option. Current information obtained from both the New South Wales and Queensland Treasuries' indicates that they will be adopting the deemed cost option. In our view, this exemption should be considered on a case-by-case basis because a blanket requirement to apply this exemption might not be appropriate (e.g. where the fair value of the assets are difficult to determine) or cost effective (e.g. where proper records of the cost of assets exist).

Should exemption be considered initially at a Crown or individual entity level?

Individual entities should consider the appropriateness of adopting this exemption. Treasury will have to consider whether this exemption should be applied to those assets that are reported only on the Crown balance sheet.

Assets and liabilities of subsidiaries, joint ventures and associates where adoption dates differ

Entities included in the CFS have the ability to determine how and when they will be adopting NZIFRS. Most entities included in the CFS indicated that they would be adopting NZIFRS at the same time as the Crown. However, Schools and Tertiary Institutions have balance dates of 31 December which is a statutory requirement and therefore they will have different adoption dates to that of CFS.

This exemption applies when subsidiaries, associates and joint ventures become first time adopters at a date different to that adopted in the ultimate consolidated financial statements in which they are accounted for. Where individual entities adopt before the date applicable to the consolidated financial statements (as in the case of schools and tertiary institutions) the carrying amounts in their separate financial statements should be recognised in the consolidated (CFS) financial statements.

Advantages	Disadvantages
• Timing and resource efficiencies since not all entities will be adopting at the same time. • Consistency with current processes.	• If not planned carefully and policy choices not communicated, entities could adopt policies that would, unnecessarily, require ongoing consolidation adjustments.

Experience

In our experience, transition dates within groups of entities differ where jurisdictions within the group do not permit concurrent adoption. However minimal information is available to determine how this exemption is applied in practice.

Should exemption be considered initially at a Crown or individual entity level?

This exemption should be considered at the Crown level to ensure the entities adopting before the Crown adopt the policies that will be applied in the CFS going forward.

Application of the transitional provisions in NZIFRS 4 Insurance Contracts

The scope of NZIFRS 4 not only covers insurance contracts as we traditionally know them, but includes all contracts where risk, other than financial risk as defined, is transferred to the issuer of the contract. This standard could therefore impact more entities, and contracts entered into by those entities, than first expected.

This exemption allows an entity to apply the transitional provisions of NZIFRS 4. If an entity adopts this exemption, it:

- Need not apply the disclosure requirements of the standard for periods beginning before 1 January 2005;
- Applies the requirements relating to unbundling of deposit components and recognition and measurement unless impracticable;
- Is permitted to reclassify some or all of its financial assets as "at fair value through profit and loss" when it changes its accounting policies for insurance liabilities (subject to changes that may arise as a result of the fair value option amendment to NZIAS 39).

Advantages	Disadvantages
• The scope of this standard is much wider than expected. Adopting the transitional provisions would significantly reduce the level of information to be obtained to satisfy full retrospective application.	• Nothing specific to note.

Experience

All those companies examined to date, to which this exemption is relevant (i.e. those having insurance contracts not previously reported under FRS 34 or FRS 35), are applying the exemption.

Should exemption be considered initially at a Crown or individual entity level?

For traditional insurance contracts, the exemption should be considered by the individual entities undertaking such activities. In respect of the more common types of transactions that could fall within the scope of this standard, such as financial guarantees, the exemption should be considered at the Crown level.

Recognition of changes in existing decommissioning/restoration liabilities that occur before date of transition

The activities of some entities included in the CFS would necessitate liabilities for decommissioning or restoration. NZIFRIC 1 requires changes in these liabilities to be added to the related assets and depreciated prospectively when the change occurs.

This exemption allows an entity to account for the "cumulative" changes at the date of transition.

Advantages	Disadvantages
• Removes the need to determine and account for changes in the liability that occurred between the date it is established and the date of transition.	• Nothing specific to note.

Experience

Our experience indicates that many entities do not have an obligation for decommissioning and restoration at the end of assets' useful lives, and therefore we are not seeing common application of this exemption. However, entities adopt the exemption where it would have a material impact and where it would be more efficient than doing retrospective calculations.

Should exemption be considered initially at a Crown or individual entity level?

Since this exemption can be applied to individual liabilities, it would be appropriate for individual entities to decide whether it would be appropriate to adopt the exemption.

Application of the transitional provisions in IFRIC 4 Determining whether an arrangement contains a lease

Entities may enter into arrangements that comprise a transaction or a series of related transactions, that do not take the legal form of a lease but convey a right to use an asset. IFRIC 4 provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with NZIAS 17 Leases.

This exemption allows an entity to apply the transitional provisions in IFRIC 4 to arrangements existing at the date of transition to NZ IFRS. Therefore the entity may determine whether such arrangement contains a lease on the basis of facts and circumstances existing at the date of transition.

Advantages	Disadvantages
• Remove the need to obtain information that existed at the time that the individual arrangements were entered into.	• Nothing specific to note.

Experience

This Interpretation was issued recently and is therefore currently being considered by early adopters.

Should exemption be considered initially at a Crown or individual entity level?

Since this exemption can be applied to individual arrangements, it would be appropriate for individual entities to consider this exemption.

From May 2005 KPMG report to the Treasury on Implementation of NZ IFRS for the Crown Financial Statements

Recognition of cumulative actuarial gains and losses in respect of employee benefits

This exemption allows entities to recognise all actuarial gains and losses on transition to NZIFRS even if they will be using the corridor approach going forward. The Government operates a superannuation scheme that is a defined benefit plan. The exemption would therefore be relevant, but since the policy of recognising all actuarial gains and losses when they arise has already been adopted for the CFS, the decision on whether or not the exemption should be adopted is not relevant.

Exemptions that are not relevant to the CFS

Write-off of cumulative translation differences at date of transition

The CFS currently do not include a foreign currency translation reserve (FCTR). Only Air New Zealand currently has a foreign subsidiary and therefore an FCTR. The choice made by Air New Zealand could therefore be adopted for the CFS.

However, it could become relevant if it is determined that some entities included in the CFS have a functional currency other than New Zealand dollars. If that is the case, an FCTR could arise and the exemption will become relevant.

Where the exemption is relevant, entities are commonly choosing to write-off cumulative translation differences where the balance on transition is a debit balance that would create a loss on future disposal of the foreign operation.

Limited retrospective application of NZIFRS 2 Share-based Payments

The Crown does not have “equity instruments” as contemplated by NZIFRS 2 and therefore will not enter into share-based payments. Since the exemption is available on a grant-by grant basis, where individual entities enters into share-based payment transactions, their treatment could be adopted in the CFS.

Splitting of compound financial instruments where the liability portion is no longer outstanding

The CFS currently do not include compound financial instruments. It is also considered unlikely that compound instruments would exist at the CFS level. Although individual entities could issue compound instruments, none have been identified to date.

The exemption is available on an instrument-by-instrument basis. Therefore should such instruments be identified in individual entities, their treatment could be adopted in the CFS.