Treasury's Analysis of NZIFRS Changes Which May Have a Mixed Group Reporting Impact for the 2013/14 Year

1 May 2014

As part of the Treasury's response to "mixed group" reporting challenges we reviewed all additions and amendments to the IFRS suite that were either effective in the 2013/14 year or could be early adopted in that year. From this, we identified 11 that needed to be examined to ascertain whether the resulting changes to accounting treatment in the individual statements of for-profit entities could flow unchanged through to the Financial Statements of Government (FSG).

To minimise adjustments for group reporting purposes, we adopted the following two-step approach:

(a) We investigated whether the change in a NZ IFRS which must be applied by for-profit entities in their individual reporting, is permissible under Crown accounting policies and PBE accounting standards; and

(b) If the change in NZ IFRS is not permissible, we determined whether the effect of the change is likely to be material at the Financial Statements of Government (FSG) level.

Where we found a change in NZ IFRS is not permissible under Crown accounting policies and PBE accounting standards and the effect of the change is likely to be material at the FSG level, for-profit entities affected by the change will need to make an adjustment to their CFISnet schedules for group reporting purposes.

A brief description of the changes to NZ IFRS standards, and the results of our assessments are contained in the following pages. Where a change to an NZ IFRS is applicable to your entity, we recommend that you refer to the actual standard for a more in-depth assessment of the effect.

As you implement new NZ IFRS changes in 2013/14, you may become aware of other potential for-profit adjustments for group reporting purposes not identified in this paper. Please email us at angela.ryan@treasury.govt.nz or emma.taylor@treasury.govt.nz with details of these so we can apply the two-step approach outlined above.

Summary of Treasury analysis of the mixed group impact of NZ IFRS changes

In the table below, a “yes” in the “adjustment required?” column means that where the change is applicable, a for-profit entity, will be required to make an adjustment to its CFISnet schedules for group reporting purposes to ensure they comply with Crown accounting policy and PBE standards.

Applicable Year	No	Item	Standard	Adjustment Required?	Comment
2013/14	1	Single Control Model	NZ IFRS 10	**Yes**	IFRS 10 establishes a single control model that applies to all entities including 'special purpose entities' (SPEs). In most cases we expect classification under both IFRS and PBE standards will be consistent. However, where the application of NZ IFRS 10 brings about a change in the assessment of control of an existing investee, or a new investee is assessed differently under IFRS and PBE control criteria, an adjustment will be required.
	2	Joint Ventures	NZ IFRS 11	**Yes**	The classification of joint arrangements carried on via a separate entity may differ between NZ IFRS 11 and PBE standards in certain circumstances. However, where the application of NZ IFRS 11 brings about a change in the classification of an existing joint arrangement or the assessment of a new joint arrangement under IFRS and PBE criteria results in differing classification, an adjustment will be required.
	3	Ask v bid prices	NZ IFRS 13	**No**	NZ IFRS 13 removes the requirement to use the bid or ask price and instead requires the price within the bid-ask spread that is most representative of fair value in the circumstances to be used. However, the use of bid prices for assets and ask prices for liabilities is still permitted under NZ IFRS 13, but is not required. This will not result in a CFISnet adjustment because the effect of adopting a price other than bid/ask will not be material.
	4	Credit value adjustment	NZ IFRS 13	**No**	The application of credit risk as an input to the valuation of a derivative or debt held at fair value is consistent with the fair value guidance in PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*. As such, credit risk adjustments can flow unchanged through to CFISnet schedules for FSG reporting.
	5	Employee Benefits – Defined Benefit Scheme	NZ IAS 19	**No**	There are some measurement and disclosure requirements which are different to PBE standards. However, these are <u>not material</u> to the FSG and no adjustment is therefore required.
	6	Stripping costs – mining	NZ IFRIC 20	**No**	IASB clarification of NZ IAS 2 *Inventories* and NZ IAS 16 *Plant, Property and Equipment*. Permissible under PBE standards as authoritative support.
2014/15	7	Novation of derivatives	NZ IAS 39	**Yes**	This amendment offers an exception to terminating a hedge where a derivative is required to be novated (in certain circumstances). Under PBE standards a novated hedge must be terminated so an adjustment will be required if this exemption is applied.
	8	Investment Entities	NZ IFRS 10	**Yes**	This amendment allows an ‘investment entity’ as defined in the standards to account for its subsidiaries at FVPL rather than applying line-by-line consolidation. Not permissible under PBE standards.
2018/19	9	Hedging	NZ IFRS 9 (2013)	**Yes**	NZ IFRS 9 brings in new hedging criteria, including: what can be hedged; what can be used to hedge; and what is an effective hedge. Adjustments will be required where PBE IPSAS 29 criteria are not met.
	10	Financial Liabilities	NZ IFRS 9 (2010)	**Yes**	This amendment requires the gains or losses resulting from credit risk on own-debt designated at fair value to be presented in OCI (unless it would create an accounting mismatch). An adjustment will be required for FSG reporting.
	11	Financial Assets	NZ IFRS 9 (2009)	**Yes**	There are a number of changes affecting recognition, measurement and disclosure options. Adjustments will be required where PBE IPSAS 29 criteria are not met.

NZ IFRS 10: Consolidated Financial Statements – Single Control Model

What has changed?

NZ IFRS 10 establishes a single model to assess whether entities, including ‘special purpose entities' (SPEs).are controlled entities. This guidance was previously provided in NZ IAS 27: *Consolidated and Separate Financial Statements* with specific guidance on SPEs covered in NZ SIC-12 *Consolidation-Special Purpose Entities.* PBE IPSAS 6 *Consolidated and Separate Financial Statements* is the equivalent of NZ IAS 27. NZ SIC-12 was not adopted into the PBE suite as the NZ SIC 12 concepts are included in the relevant sections of the integral guidance of PBE IPSAS 6.

Is it permissible under PBE standards?

We examined this standard to see whether the control principles in IFRS 10 were consistent with existing standards and thus would be applicable under PBE standards. However, after due consideration, we found that application of the control principles and guidance of NZ IFRS 10 is not always the same as under existing standards. In brief, the main differences are:

NZ IAS 27, SIC 12 , PBE IPSAS 6	NZ IFRS 10
Control of an entity requires an investee to have the power to govern the financial and operating policies of an entity so as to obtain benefits from is activities. Control of an SPE is based on risks and rewards	Control of an entity, <u>including an SPE</u> requires an investee to have · Power over the investee; · Exposure, or rights, to variable returns from its involvement with the investee; and · The ability to use its power to affect the amount of the investor’s returns.
The idea that an investor could control of an investee while holding less than 50% of voting rights is implicit in NZ IAS 27 but not explicitly stated.	NZ IFRS 10 provides specific application guidance for assessing control when less than 50% of voting rights are held by an investor.
Control requires the investor to have the current ability to exercise potential voting rights.	Control includes assessment of the substance of potential voting rights not just whether they are exercisable.

While we would expect that the outcome of applying the two different control tests will be the same in most cases, we cannot assume that the result will always be the same. There could be a difference where the ownership/power[1] structure is complex, and/or there are potential voting rights to consider.

In addition, there is a particular risk that the treatment of SPE’s could change as the test under NZ IFRS 10 has moved away from consideration of who bears the risks and rewards of ownership.

Is the impact material?

Due to the variability of investment values we cannot rely on the principle of materiality to make a consistent determination at the FSG level as to whether for-profit entities affected by this change will need to make an adjustment.

[1] An investor has <u>power</u> over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, i.e. the activities that significantly affect the investee’s returns.

What does this mean for for-profit entities?

All existing investees will need to be assessed under NZ IFRS 10 and all future investees will need to be assessed under both NZ IFRS 10 and the applicable PBE standard. Where the application of NZIFRS 10 brings about a change in the assessment of control of an existing investee, or a new investee is assessed differently under IFRS and PBE control criteria, an adjustment will be required.

NZ IFRS 11: Joint Arrangements

What has changed?

The principle of NZ IFRS 11 is that a party to a joint arrangement should account for it based on its rights and obligations arising from the arrangement not the structure of the arrangement. This differs from the principle of PBE IPSAS 8[1] where the classification of a joint arrangement (and therefore its accounting treatment) flows from its structure.

Is it permissible under PBE standards?

We examined this standard to see whether the accounting treatment prescribed was consistent with the relevant PBE standard. In this case, we found one difference that could have an impact.

The difference arises where contractual arrangements reverse or modify the rights and obligations that would otherwise pertain to the separate vehicle being used for the joint venture. Under NZ IFRS 11, such circumstances are reported as joint operations and the parties sharing control recognise their relevant share of income, expenses assets and liabilities. Under PBE IPSAS 8, if a separate vehicle is used, it is equity accounted as a jointly controlled entity or proportionate consolidation is applied. This difference is illustrated below.

<table>
<tr><td colspan="3">PBE IPSAS 8 (NZ IAS 31 PBE for 2013/14)</td></tr>
<tr><td colspan="2"><u>Not</u> structured through separate vehicle</td><td>Structured through <u>separate</u> vehicle</td></tr>
<tr><td>Jointly controlled operation</td><td>Jointly controlled assets</td><td>Jointly controlled entity</td></tr>
<tr><td>Recognise relevant share of income, expenses, assets and liabilities in venturers separate financial statements</td><td>Recognise relevant share of income, expenses, assets and liabilities in venturers separate financial statements</td><td>Equity account
or
proportionate consolidation*</td></tr>
</table>

**This treatment is <u>not an option</u> under Crown accounting policies.*

<table>
<tr><td colspan="3">NZ IFRS 11</td></tr>
<tr><td><u>Not</u> structured through a separate vehicle</td><td colspan="2">Structured through a <u>separate</u> vehicle</td></tr>
<tr><td>Joint operation</td><td>Joint operation[2]</td><td>Joint venture[3]</td></tr>
<tr><td>Recognise relevant share of income, expenses, assets and liabilities in venturers separate financial statements</td><td>Recognise relevant share of income, expenses, assets and liabilities in venturers separate financial statements</td><td>equity account only</td></tr>
</table>

What does this mean for for-profit entities?

The changes mean that where you have a joint arrangement which is structured through a separate entity, you will still need to look at the legal form of that and other associated contractual arrangements to ascertain whether it is a joint venture or a joint operation under NZ IFRS 11.

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[1] And the equivalent to PBE IPSAS 8 for 2013/14: NZ IAS 31 (PBE).

[2] A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.

[3] A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers.

As we cannot assume that the assessments under NZ IFRS 11 and PBE IPSAS 8 will produce the same classification of a joint arrangement you will need to assess your existing *jointly controlled entities* and any new joint arrangements under both standards (existing joint operations should remain unaffected).

However, for Government reporting entities, we do not expect that differing classifications of the same arrangement under the two standards will be a common occurrence.

In the rare occasion where the application of NZ IFRS 11 brings about a change in the classification of an existing joint arrangement or the assessment of a new joint arrangement under IFRS and PBE criteria results in differing classification, an adjustment will be required.

We also noted that NZ IFRS 11 has removed the option of proportionate consolidation for joint ventures. As this is now consistent with Crown policy, no adjustment should be required as a result of this change.

NZ IFRS 13: *Fair Value* – Ask/Bid Prices

What has changed?

NZ IFRS 13 *Fair Value Measurement* applies to all IFRSs that require or permit fair value measurements or disclosures about fair value measurement. NZ IFRS 13 defines fair value, sets out a framework for measuring fair value, and requires disclosures about fair values.

In particular NZ IFRS 13 removes the requirement to use the bid or ask price and instead requires the price within the bid-ask spread that is most representative of fair value in the circumstances to be used. However, the use of bid prices for assets and ask prices for liabilities is still permitted under NZ IFRS 13, but is not required

Is it permissible under PBE standards?

As we could not clearly conclude that the range of prices allowed under NZ IFRS 13 were permissible under PBE standards, we decided that we would need to look at whether the introduction of a greater range of prices would have a material impact on the FSG.

Is the impact of the change material?

To establish whether the range of prices allowed under NZ IFRS 13 would have a material impact on the FSG we looked at the rates currently being applied by various for-profit entities. We found that a number of large for-profit entities have continued to use mid-rates since transition to IFRS in 2008 and concluded that these agencies have no reason to change those rates on adoption of NZ IFRS 13. We also believe that agencies who have embedded bid/ask rates into their systems are also unlikely to change. In addition, we also considered the materiality of the adjustments that were made upon transition to NZ IFRS standards. Our conclusion is that the impact would not be material.

What does this mean for for-profits?

After considering whether NZ IFRS 13 would have a material impact on the FSG, we have concluded that values based on prices within the ask-bid range allowed under NZ IFRS 13 can be used in your CFISNet submissions.

NZ IFRS 13: Fair Value – Credit Value Adjustment

What has changed?

One of the outcomes of the introduction of NZ IFRS 13 has been to make it clear that credit risk is to be included as an input to the valuation of a derivative or debt held at fair value.

Is it permissible under PBE standards?

Yes. The application of credit risk as an input to the valuation of a derivative or debt held at fair value is consistent with the fair value guidance in PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*.

What does this mean for for-profit entities?

Adjustments relating to the application of credit risk in valuing derivatives or debt held at fair value can flow unchanged through to CFISnet schedules for the Financial Statements of Government.

NZ IAS 19: Employee Benefits – Defined Benefit Schemes

What has changed?

The two main changes are the removal of the corridor approach which allowed some actuarial losses to be held "off balance sheet"; and the presentation of some items in the OCI which previously were disclosed in the P&L.

Is it permissible under PBE standards?

While the corridor approach is already prohibited under current Crown accounting policy, some of the presentation changes are not consistent with PBE IPSAS and Crown policy.

Is the impact of the change material?

We do not consider these changes to be material as we are aware of only one affected entity.

What does this mean for for-profit entities?

If your entity is a for-for-profit entity with defined benefit scheme you will not be required to make any adjustments to your accounts for CFISNet submission purposes.

NZ IFRIC 20: Financial Instruments – Stripping Costs in the Production Phase of a Surface Mine.

What has changed?

IFRIC 20 was developed to eliminate diversity in accounting for the removal of overburden in open-cut mining operations by providing guidance on when and how to account separately for the two benefits arising from the stripping activity (inventory and access to ore), as well as how to measure these benefits both initially and subsequently.

Is it permissible under PBE standards?

We consider the application of NZ IFRIC 20 to be permissible under PBE standards as its aim is to clarify existing treatment under IFRS standards but is not a change in treatment. We also consider NZ IFRIC to be authoritative support under the PBE framework.

What does this mean for for-profit entities?

This means that if the application of NZ IFRIC 20 results in a change in classification of your inventory or mining assets, you will not be required to make any adjustments to your accounts for CFISNet submission purposes.

Amendments to NZ IAS 39 and 9: Financial Instruments – Novation of Derivatives

What has changed?

Central clearing of derivatives is now required across Europe and the US as a result of legislative changes, and this requires novating (substituting a new contract for an old one) ‘over the counter’ derivatives to a central counterparty. NZ IAS 39 previously required that hedge accounting of those derivatives must be discontinued when this happens[1].

NZ IAS 39 was therefore amended to provide relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument meets certain criteria. Similar relief will be included in NZ IFRS 9: Financial Instruments.

Is it permissible under PBE standards?

Relief offered by this amendment is not available to entities applying PBE standards.

Is the impact material?

We do not expect this amendment to have widespread application. However, at this stage we are unaware of any entities applying hedge accounting who are affected by the central clearing of derivatives, so we are therefore not in a position to assess materiality.

What does this mean for for-profit entities?

If your entity is applying the relief afforded by this amendment, you will need to make an adjustment to your CFISNet submission to ensure your accounting treatment complies with PBE standards and Crown accounting policy.

1 (NZ IAS 39 requires that hedge accounting is discontinued when a hedging instrument expires or is sold, terminated or exercised, unless the replacement or rollover of a hedging instrument into another hedging instrument is part of the entity’s documented hedging strategy).

NZ IFRS 10: Consolidated Financial Statements – *Investment Entities*

What has changed?

This amendment to NZ IFRS 10 provides an exception to the rule that all controlled entities must be consolidated. It allows a parent entity that meets the criteria of an investment entity (as defined in the standard) to measure its controlled entities at fair value through profit or loss in accordance with NZ IAS 39 /NZ IFRS 9: *Financial Instruments* instead of consolidating those entities' assets and liabilities line by line.

Is it permissible under PBE standards?

We concluded that the accounting treatment that investment entities are able to apply to controlled entities is not permissible under PBE standards as the designation 'investment entity' and the associated exception are not part of those standards

Moreover, this outcome is consistent with NZ IFRS 10 which does not allow this exemption to flow through to the parent of an investment entity if the parent itself is not an investment entity.

Is the impact material?

Due to the variability of investment values we cannot rely on the principle of materiality to make a consistent determination at the FSG level as to whether for-profit entities affected by this change will need to make an adjustment.

What does this mean for for-profit entities?

If your entity is deemed an investment entity, the impact of the consolidation exception will need to be adjusted upon submission to CFISNet to bring your treatment of controlled entities into line with PBE standards and Crown policy.

However, we are aware the IPSASB is considering the investment entity exemption as part of ED 49. ED 49 proposes to allow the exemption to flow to a parent of an investment entity; even in the parent itself is not an investment entity. If these current IPSASB proposals are accepted and included in the final NZ PBE standard, the adjustment to the FSG noted above may only be required for a limited time.

NZ IFRS 9: *Financial Instruments* – Hedge Accounting

What has changed?

The hedge accounting requirements of NZ IFRS 9 are designed to provide better links between an entity's risk management activities, the rationale for hedging and the impact of hedging on the financial statements. This involved changes to guidance in the following areas.

- Hedge effectiveness testing
- Ability to hedge a risk <u>component</u> only
- Different treatment of hedging costs

Is it permissible under PBE standards?

We ascertained from our research that hedge arrangements which are able to be designated as hedges under NZ IFRS 9 will <u>not</u> be permissible under PBE IPSAS 29 unless the following three criteria are met:

1. The hedge is permissible under both standards
2. The hedge documentation meets the requirements of both standards
3. The hedge is deemed effective under both standards.

What does this mean for for-profit entities?

If your agency is adopting NZ IFRS 9 (2013) you will need to assess your hedges under the above criteria each reporting period. Where those criteria are not met, you will need to make adjustments to your CFISnet schedules for group financial reporting to bring your accounting treatment into line with PBE standards and Crown accounting policy.

While it's up to each agency to determine how they make these adjustments, we can envisage a couple of options as follows:

1. Prepare documentation and test for effectiveness under both standards. Reverse the effect of IFRS 9 based entries in your data-load and replace with accounting entries based on PBE IPSAS 29/NZ IAS 39
2. Prepare documentation for NZ IFRS 9 only and have no hedging for FSG reporting. Reverse out any hedge accounting effects in your CFISNet schedules for group financial reporting.

Unfortunately, whichever approach you choose, we envisage that it will take considerable time and effort to maintain the records to support these adjustments. Please bear this in mind when considering early adoption of NZ IFRS 9.

NZ IFRS 9 (2010): *Financial Instruments* – Liabilities

What has changed?

Under NZ IFRS 9 the portion of the change in the fair value of a FVO liability[1] that is caused by credit risk should be recognised in other comprehensive income (OCI) unless doing so would create an accounting mismatch.

Is it permissible under PBE standards?

We have determined that this is not permissible under PBE IPSAS 29 as this requires gains or losses resulting from the change in the fair value of a liability (which are not part of a hedging relationship) to be recognised in surplus or deficit.

What does this mean for for-profit entities?

If you are adopting NZ IFRS 9 (2010), gains and losses disclosed in OCI will need to be reclassified to profit or loss in your CFISNet schedules to bring your accounting treatment into line with PBE standards and Crown policy.

[1] A liability recognised at fair value on initial recognition.

NZ IFRS 9 (2010): *Financial Instruments* – Assets

What has changed?

The main changes are:

- debt instruments meeting both a 'business model' test and a 'cash flow characteristics' test are measured at amortised cost (the use of fair value is optional in some limited circumstance)
- investments in equity instruments can be designated as 'fair value through other comprehensive income' with only dividends being recognised in profit or loss
- all other instruments (including all derivatives) are measured at fair value with changes recognised in the profit or loss
- the concept of 'embedded derivatives' does not apply to financial assets within the scope of the standard and the entire instrument must be classified and measured in accordance with the above guidelines
- unquoted equity instruments can no longer be measured at cost less impairment (must be at fair value).

Are these permissible under PBE standards?

Our analysis revealed that it is not possible to make a general verdict as to the permissibility of the application of NZ IFRS 9 (2010) under PBE IPSAS 29. NZ IFRS 9 has a number of implications for the treatment of financial assets, some of which will result in different recognition, measurement and disclosure of items, depending on whether particular criteria are met and which treatment options are elected.

Therefore, the question of whether the application of NZ IFRS 9 is permissible will depend on the circumstances surrounding each financial asset.

e.g. During the year an entity purchases an equity interest in another entity, but at balance date, the value of that investment has fallen below cost. Under PBE IPSAS 29, if the decline in fair value below cost is considered to be significant or prolonged, this would represent an impairment in the value of the investment that must be taken through profit or loss. However, under NZ IFRS 9 if an entity elects to account for the equity investment through OCI, all declines in value below cost is presented in OCI and impairment is not considered.

What does this mean for for-profit entities?

If your agency is adopting NZ IFRS 9, you will need to consider how both standards impact the accounting treatment of its various financial assets.

Where the treatment applied under NZ IFRS 9 produces a result which is not consistent with treatment allowed under PBE IPSAS 29, you will need to make adjustments to your CFISnet schedules to bring them into line with PBE standards and Crown accounting policy.