ASSURANCE ALERT

FOR-PROFIT ENTITIES - IMPACTS OF TRANSITIONING FROM DIFFERENTIAL REPORTING TO NZ IFRS REDUCED DISCLOSURE REGIME: (6) DEVELOPMENT COSTS ASSESSED FOR CAPITALISATION

As highlighted in the December 2014 edition of *Assurance Alert*, there are a number of key differences for for-profit entities to consider when transitioning from differential reporting (Tier 3) to NZ IFRS Reduced Disclosure Regime (Tier 2).

In this article we will be addressing the impact of the removal of the option to expense development costs.

Overview of the requirements of NZ IFRS (Diff Rep) and NZ IFRS (RDR)

Paragraph NZ 7.1 of NZ IAS 38 (Diff Rep) *Intangible Assets* provides entities with the option to expense development related costs as they are incurred, rather than assess them for possible capitalisation subject to meeting the strict criteria of paragraph 57 of the standard.

Under NZ IFRS (RDR) this option has been removed.

Therefore, Tier 3 NZ IFRS (Diff Rep) entities that are required to transition to Tier 2 NZ IFRS (RDR) will be required to assess **ALL** development related costs for capitalisation.

Capitalising development costs – Basic Summary

i. Overview of accounting for development costs

Development related costs are usually entangled within an overall *research and development* project(s) being undertaken by an entity.

Research activities are those relating to the original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development activities are those that relate to the application of findings from research activities.

It is quite clear that research activities and development activities are very much mutually exclusive, and that the determination of whether costs relate to research or development occurs at a point in time (i.e. when findings from research are applied to future development).

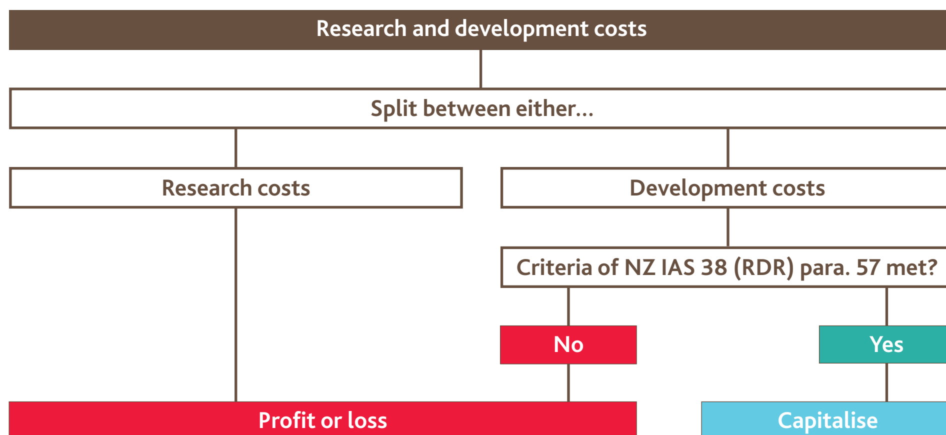
IN THIS ISSUE

- For-profit entities - Impacts of transitioning from Differential Reporting to NZ IFRS Reduced Disclosure Regime: (6) Development costs assessed for capitalisation
- For-profit entities - Impacts of transitioning from Differential Reporting to NZ IFRS Reduced Disclosure Regime: (7) Use of spot-rate for foreign currency transactions
- NZASB issues amendments to NZ IAS 1 *Presentation of Financial Statements*, and NZ IFRS 10 *Consolidated Financial Statements*
- New BDO Publications

This distinction is important as the accounting is different between research costs and development costs, specifically:

- Research costs are expensed in profit or loss as incurred
- Development costs are assessed against the six criteria of NZ IAS 38 (RDR) paragraph 57:
  - If criteria are met: capitalise the costs as an intangible asset
  - If criteria are not met: expense in profit or loss as incurred.

This is summarised in the diagram below.



Therefore, there are two key judgements that management must make, being:

1. At which point do research activities become development activities? And,
2. Have all six criteria to capitalise development costs been met?

ii. Point at which research activities become development activities

Examples of research activities include those that are:

- Aimed at obtaining new knowledge
- Searching for potential alternatives (i.e. materials, processes, products etc.)
- Formulation, design, evaluation and the final selection of:
  - Findings and other knowledge, and/or
  - Potential alternatives.

Development activities, by definition, begin only once research activities have ceased. That is, once an entity has evaluated its findings from its initial investigation, and then formulated a plan for the future based on those findings. Examples of development activities would include:

- Design, construction, and testing of prototypes and/or alternatives
- Design, construction, and operation of pilot plans (i.e. at a scale that is not economically feasible commercially
- Design of new components for new technology (i.e. tools, jigs, moulds, dies etc.).

The distinction is important as it highlights that during the ***research phase*** an entity would be unable to demonstrate that there would be probable future economic benefits from the costs incurred, and therefore it would be inappropriate (and contradictory to the conceptual framework) to recognise an asset in relation to these costs. In contrast, the development phase is further advanced with clear goals, objectives, and outcomes.

As stated above, this may require **significant management judgement**, particularly in large and complex projects with multiple phases and/or components.

iii. Criteria to capitalise development costs

In order for development costs to be capitalised, management must ensure that **ALL** six criteria of NZ IAS 38 (RDR) paragraph 57 have been met, namely, management must demonstrate:

i. The technical feasibility of completing the intangible asset (for use or sale)

ii. Their intention to complete the intangible asset (for use or sale).

iii. Their ability to use or sell the intangible asset.

iv. How the intangible asset will generate probable future economic benefits, including demonstrating:
   - The existence of a market for the intangible asset or its output the intangible asset, or
   - The usefulness of the intangible asset (if it is to be used internally).

   Further, management must apply the principals of NZ IAS 36 *Impairment of Assets* in respect of:
   - In assessing future economic benefits
   - Cash-generating-units where future economic benefits are generated only in combination with other assets.

v. The availability of adequate technical, financial and other resources to complete the project, and to then use or sell the intangible asset, for example:
   - The formalisation of a reasonable business plan for the project
   - External commitment to provide funds for the project.

vi. Their ability to measure reliably the expenditure attributable to the intangible asset during its development, for example
   - Payroll systems that can adequately allocate time-and-cost
   - Ability to identifying expenditure incurred on procuring copyrights, licences, specific tangible and intangible components of the project.

As stated above, this may require significant management judgement, particularly in large and complex projects with multiple phases and/or components.

iv. Subsequent measurement of capitalised development costs

The six criteria detailed above are applied continuously, and therefore at least at each reporting date. Capitalisation of development costs ceases at the specific point in time in which any one of the six criteria is not met, in which case any further costs are recognised in profit or loss as incurred.

Where this is the case (and in particular where the project is discontinued), the capitalised development costs to date are tested for impairment in accordance with NZ IAS 36 (and likely written off completely).

Once development has completed, the resulting asset is subsequently amortised on a systematic basis over its useful life and assessed for indicators of impairment.

v. Transition to NZ IFRS (RDR) – previously expensed development costs

Entities that are transitioning from NZ IFRS (Diff Rep) to NZ IFRS (RDR) must apply the requirements of NZ IFRS 1 (RDR) *First-time Adoption of New Zealand Equivalents to International Financial Reporting Standards.*

In respect to development costs that were previously expensed under NZ IFRS 38 (Diff Rep), a potential conflict arises in an entity's opening statement of financial position

prepared in accordance with NZ IFRS (RDR), being:

- NZ IFRS 1 (RDR) requires an entity to recognise all intangible assets that meet the recognition requirements of NZ IAS 38 (RDR) (even when those costs have been previously expensed), however
- The benefit of hindsight ***cannot*** be used in determining whether the recognition requirements have been met.

Therefore, unless the entity already has an established comprehensive monitoring system for its research and development activity, it is unlikely that the entity will be able to retrospectively 'demonstrate' compliance with all six development cost capitalisation criteria (in particular (iv), (v), and (vi)).

Whether or not this is the case will be a matter of significant management judgement.

Assuming retrospective compliance cannot be demonstrated for periods prior to transition to NZ IFRS (RDR) for a single project:

- An entity would not be able retrospectively capitalise development activity costs that were expensed prior to transition to NZ IFRS (RDR), but
- Would be required to consider capitalisation of development activity costs subsequent to transition to NZ IFRS (RDR).

What should affected entities be doing now?

In terms of recognition and measurement, the change will have no impact for:

- Tier 3 for-profit entities that are already capitalising development costs (i.e. opting not to apply the exiting NZ IFRS (Diff Rep) exemption), or
- Entities that do not engage in research and development activities.

In contrast, the change will impact:

- Tier 3 for-profit entities that are currently expensing development costs (i.e. applying the exiting NZ IFRS (Diff Rep) exemption), or
- Entities that are likely to engage in research and development activities in the future.

The significance of this change should not be underestimated, and affected entities are strongly encouraged to assess and address the impact of this change as early as possible in order to mitigate potential issues in the transition to NZ IFRS (RDR), in particular the significant judgements surrounding:

- When research activities cease, and development activities begin
- Whether or not all of the six criteria to capitalise development costs have been met
- Whether develop costs that were previously expensed under NZ IFRS (Diff Rep) can be capitalised as at the date of transition to NZ IFRS (RDR).

For more on the above, please contact your local BDO representative

FOR-PROFIT ENTITIES - IMPACTS OF TRANSITIONING FROM DIFFERENTIAL REPORTING TO NZ IFRS REDUCED DISCLOSURE REGIME: (7) USE OF SPOT-RATE FOR FOREIGN CURRENCY TRANSACTIONS

As highlighted earlier in this edition of Assurance Alert, there are a number of key differences for for-profit entities to consider when transitioning from differential reporting (Tier 3) to NZ IFRS Reduced Disclosure Regime (Tier 2).

In this article we will be addressing the impact of the removal of the option for entities to use the 'settlement-rate', rather than the 'spot-rate', for transactions denominated in foreign currencies.

Overview of the requirements of NZ IFRS (Diff Rep) and NZ IFRS (RDR)

Paragraph NZ 7.1 of NZ IAS 21 (Diff Rep) *The Effects of Changes in Foreign Exchange Rates* provides entities with the option not to account for foreign exchange transactions using the spot-rate (as required by paragraph 21), and instead may use the 'settlement rate'.

Under NZ IFRS (RDR) this option has been removed, and therefore Tier 3 entities that will be required to transition to Tier 2 will be required to account for foreign exchange transactions using the spot rate in **ALL** circumstances.

Spot-rate vs. Settlement-rate

i. Definitions

The spot-rate refers to the foreign exchange rate on the date upon which the transaction is recognised in accordance with the other NZ IFRS(s) that apply to the transaction (for e.g. NZ IAS 18 Revenue regarding the sale of goods and services).

The settlement-rate refers to the foreign exchange rate on the date upon which a transaction is settled.

ii. Practical application – basic example

In practice, the use of different rates in accounting for foreign currency transactions results in:

- Elements within foreign currency transactions (i.e. stock, plant and equipment, revenue etc.) being recognised at different amounts
- More frequent recognition of foreign exchange gains or losses in profit or life.

To illustrate, consider the simple examples below.

Note that the examples below use **daily** spot rates. Paragraph 22 of NZ IAS 21 (RDR) allows the use of an average spot rate (e.g. weekly, monthly) in instances where there is no significant fluctuation in the foreign exchange rate during the period over which the average is determined.

The use and period of spot rate averaging will need to be continuously assessed by management on a currency-by-currency basis to ensure that its application is reasonable.

Example 1 – 'Vanilla' purchase of inventory from an overseas supplier

Date	TRANSACTION DETAILS	USD:NXD
1 Jan	Company NZ places an order for USD$1,000 worth of stock from its US based supplier Company US.	0.78
7 Jan	Company US dispatches the stock to Company NZ, and emails through an invoice to Company NZ. Terms of trade are that the risks and rewards of the stock transfer from Company US to Company NZ at the point at which the goods are **dispatched**.	0.80
15 Feb	Stock arrives at Company NZ's premises.	0.74
20 Feb	Company NZ pays invoice to Company US	0.76

Continued on next page.

The journals that Company NZ would raise under each treatment would be

Date	SETTLEMENT-RATE TREATMENT	SPOT-RATE TREATMENT
1 Jan	*No Journal*	*No journal*
7 Jan	*Recognition of inventory (risk and rewards transfer)* Dr Inventory 1,250 Cr Accounts Payable 1,250 = USD$1,000 / 0.80	*Recognition of inventory (risk and rewards transfer)* Dr Inventory 1,250 Cr Accounts Payable 1,250 = USD$1,000 / 0.80
15 Feb	*No journal*	*No journal*
20 Feb	*Payment of invoice* Dr Accounts Payable 1,250 Dr Inventory 65 Cr Bank 1,315 = USD$1,000 / 0.76	*Payment of invoice* Dr Accounts Payable 1,250 **Dr Foreign exchange (gain)/loss (P&L) 65** Cr Bank 1,315 = USD$1,000 / 0.76
Total result	Inventory $1,315* Bank ($1,315) * = $1,250 + 65	Inventory $1,250 Foreign exchange loss (P&L) $65 Bank ($1,315)

As you can see above, the different treatment results in inventory being recognised at a higher amount (in this example) under the settlement-rate treatment, essentially 'absorbing' the foreign exchange loss ($55).

Eventually this difference 'washes-out' through profit or loss once the inventory is sold (i.e. there will be a lower gross profit as the costs of goods sold will be higher under the settlement-rate treatment (in this example)).

Example 2 – 'Vanilla' purchase of inventory from an overseas supplier with an economic hedge

	TRANSACTION DETAILS	USD:NXD
1 Jan	Company NZ places an order for USD$1,000 worth of stock from its US based supplier Company US. Company NZ takes out a forward exchange contract with its bank to lock in the forex rate: – For USD$1,000 – To be settled on the 20th February – At the rate of 0.78. (Note that for the purposes of this example it has been determined Company NZ **does not** qualify, and is therefore not applying, hedge accounting per NZ IAS 39 *Financial Instruments: Recognition and Measurement*).	0.78
7 Jan	Company US dispatches the stock to Company NZ, and emails through an invoice to Company NZ. Terms of trade are that the risks and rewards of the stock transfer from Company US to Company NZ at the point at which the goods are **dispatched**.	0.80
15 Feb	Stock arrives at Company NZ's premises.	0.74
20 Feb	Company NZ pays invoice to Company US	0.76

Article continued on next page.

The journals that Company NZ would raise under each treatment would be

Date	SETTLEMENT-RATE TREATMENT	SPOT-RATE TREATMENT
1 Jan	*No Journal*	*No journal*
7 Jan	*Recognition of inventory (risk and rewards transfer)* Dr Inventory 1,282 Cr Accounts Payable 1,282 = USD$1,000 / **0.78**	*Recognition of inventory (risk and rewards transfer)* Dr Inventory 1,250 Cr Accounts Payable 1,250 = USD$1,000 / 0.80
15 Feb	*No journal*	*No journal*
20 Feb	*Payment of invoice* *Dr Accounts Payable 1,282* **Dr Foreign exchange (gain)/loss (P&L) 33** *Cr Bank 1,315* *= USD$1,000 / 0.76* *Settlement of forward exchange contract* *Dr Bank 33* **Cr Foreign exchange (gain)/loss (P&L) 33** **= (USD$1,000 / 0.76) - (USD$1,000 / 0.78)**	*Payment of invoice* Dr Accounts Payable 1,250 **Dr Foreign exchange (gain)/loss (P&L) 65** Cr Bank 1,315 = USD$1,000 / 0.76 Settlement of forward exchange contract Dr Bank 33 **Cr Foreign exchange (gain)/loss (P&L) 33** **= (USD$1,000 / 0.76) - (USD$1,000 / 0.78)**
Total Result	Inventory $1,282 Foreign exchange (gain)/loss $nil* Bank $(1,282)** * = $33 + $(33) ** = $33 + $(1,315)	Inventory $1,250 Foreign exchange loss (P&L) $32* Bank $(1,282) * = $65 + $(33)

Note, that in the above transaction Company NZ has taken out a forward exchange contract in the **exact amount** and the **exact settlement date** of the original foreign exchange transaction.

Therefore, in applying the settlement-rate option, Company NZ is able to apply the foreign exchange rate that was 'locked-in' by the forward exchange contract.

As with *Example 1* above, the different treatment results in inventory being recognised at a higher amount (in this example) under the *settlement-rate* treatment, essentially 'absorbing' the foreign exchange loss – however a portion of this ($22) has been mitigated through the use of the forward exchange contract.

Eventually the difference ($33) 'washes-out' through profit or loss once the inventory is sold (i.e. there will be a lower gross profit as the costs of goods sold will be higher under the *settlement-rate treatment* (in this example)).

iii. Summary of the overall impact

In respect of the accounting, moving from the *settlement-rate* treatment to *spot-rate* treatment will result in:

- Corresponding goods and services purchased/sold being recognised at different amounts
- The recognition and presentation of (realised) foreign exchange gains/(losses)
- Presentation of new line items in the financial statements.

In respect of the practical application, moving from the *settlement-rate* treatment to *spot-rate* treatment will result in different foreign exchange rates having to be applied at different phases of a foreign exchange transaction

What should affected entities be doing now?

Entities that will be required to move from the *settlement-rate* treatment to *spot-rate* treatment will need to review their accounting systems to ensure that they are able to be update to apply the correct foreign exchange rates to the different phases of a foreign exchange contract.

In addition, these entities will also need to begin preparing comparative financial statements from the date of initial application of NZ IFRS (RDR) under the spot-rate treatment.

The significance of this change should not be underestimated, especially those effected entities that have significant foreign exchange transactions and/or are exposed to highly volatile foreign currencies. Effected entities are strongly encouraged to assess and address the impact of this change as early as possible in order to mitigate potential issues in the transition to NZ IFRS (RDR).

For more on the above, please contact your local BDO representative

NZASB ISSUES AMENDMENTS TO NZ IAS 1 PRESENTATION OF FINANCIAL STATEMENTS, AND NZ IFRS 10 CONSOLIDATED FINANCIAL STATEMENTS

In February 2015 the New Zealand Accounting Standards Board (NZASB) issued two new amendments:

- Disclosure Initiative -Amendments to NZ IAS 1; and
- Investment Entities: Applying the Consolidation Exception - Amendments to NZ IFRS 10, NZ IFRS 12 and NZ IAS 28.

i. Disclosure Initiative

The amendment makes a number of changes to NZ IAS 1 *Presentation of Financial Statements*, including:

Amendment	Summary of details
i. Materiality	► The aggregation or disaggregation of line items should not obscure useful information. ► Materiality applies to each of the primary financial statements, the notes, and each specific disclosure required by NZ IFRSs.
ii. Line items in primary financial statements	► Clarification that the presentation of line items specified by NZ IAS 1 in respect of the 'statement of profit or loss and other comprehensive income' and 'statement of financial position' can be disaggregated where this is relevant to an understanding of the entity's financial position and performance. ► Sub-totals used in the primary financial statements must be: – Made up of items recognised in accordance with NZ IFRSs – Presented and labelled in a manner that makes them understandable – Consistent from period to period – Displayed with no more prominence than the subtotals and totals required by NZ IFRSs.
iii. Notes to the financial statements	► Clarification that the order listed in paragraph 114(c) is illustrative only, and that the understandability and comparability of financial statements must be considered when determining the order of the notes.
iv. Accounting policies	► The examples in paragraph 120 relating to income taxes and foreign exchange gains and losses have been removed (it was determined that these were unclear about why a user of financial statements would always expect these specific policies to be disclosed).
v. Equity accounted investments (i.e. associates and joint ventures)	► Clarification that an entity's share of other comprehensive income would be split between those items that will and will not be reclassified to profit or loss, and presented in aggregate as single line items within those two groups. Refer to Figure 1 below:

Figure 1: Effects on the other comprehensive income section of the statement of profit or loss and other comprehensive income of the amendments regarding equity accounted investees.

	20X5 (Post amendment)	20X5 (Post amendment)
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	xxx	xxx
Share of equity accounted investees gains on property revaluation	400	-
Share of other comprehensive income of equity accounted investees	-	400
Income tax relating to items that will not be reclassified	xxx	xxx
	xxx	**xxx**
Items that may be reclassified subsequently to profit or loss:		
Foreign currency translation differences	xxx	xxx
Fair value change in available-for-sale financial assets	xxx	xxx
Share of equity accounted investees foreign currency translation differences	(300)	
Share of equity accounted investees fair value change in available-for-sale financial assets	100	
Share of other comprehensive income of equity accounted investees	-	200
Income tax relating to items that may be reclassified	xxx	xxx
	xxx	**xxx**
Other comprehensive income for the year, net of tax	**xxx**	**xxx**

Although the amendments do not introduce many new requirements, entities would be advised to revisit:

- Their application of materiality
- The level of aggregation and disaggregation of line items in the financial statements
- The use of subtotals
- Presenting information in an orderly and logical manner
- The order of the notes to the financial statements
- The content and presentation of accounting policies
- The amount of information to disclose for material transactions so that the economic substance of the transaction can be adequately explained
- Which accounting policies are significant to users of financial statements in understanding specific transactions
- Presentation of other comprehensive income regarding equity accounted investees.

The focus on disclosing material and relevant information is likely to require on-going application of judgement. Entities may also consider engagement with their auditors and shareholders as part of their process of determining which disclosures are material and relevant for the current reporting period.

The amendments are effective for annual periods beginning on or after 1 January 2016, with early application permitted.

The amendment can be accessed on the XRB's website by clicking here.

ii. Investment Entities: Applying the Consolidation Exception

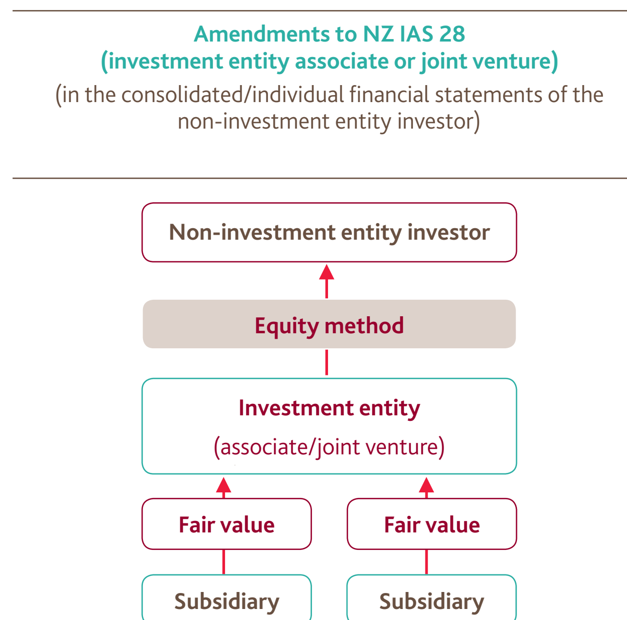
The amendment clarifies several aspects of NZ IFRS 10 *Consolidated Financial Statements*, NZ IFRS 12 *Disclosure of Interests in Other Entities* and NZ IAS 28 *Interests in Associates and Joint Ventures* in relation to entities that meet the definition of an *investment entity*.

Accordingly, this amendment is only relevant to those (very few) entities that meet the definition of an investment entity in accordance with criteria prescribed by NZ IFRS 10 paragraph 27.

Changes introduced by the amendment include:

Amendment	Summary of details
i. Scope exemption	▶ Clarification that so long as the entity's ultimate (or intermediate) parent produces financial statements that are in compliance with NZ IFRS 10 (including an investment entity that accounts for its interests in all of its subsidiaries at fair value rather than consolidating them), the exemption from preparing its own consolidated financial statements is available to the intermediate parent entity (so long as the other criteria of NZ IFRS 10.4(a) have been met).
ii. Accounting for a subsidiary that provides services related to its investment activities that is also an investment entity.	▶ Clarification that an investment entity parent consolidates a subsidiary only when: – The subsidiary is not itself an investment entity, and – The subsidiary's main purpose is to provide services that relate to the investment entity's investment activities.
iii. Disclosure requirements (NZ IFRS 12)	▶ Clarification that that an investment entity that prepares financial statements in which all of its subsidiaries are measured at *fair value through profit or loss* is required to present the disclosures relating to investment entities as required by NZ IFRS 12.
iv. (iv) Applying the equity method to interests in associates and joint ventures that are investment entities, by an investor that is **not** an investment entity	▶ Clarification that when applying the equity method to interests in associates and/or joint ventures that are investment entities, by an entity that is not itself an investment entity, the entity may retain the fair value measurement applied by the investment entity associates and/or joint ventures. Refer to Figure 2 below:

Figure 2 – Amendments to NZ IAS 28 for non-investment entity investors in equity accounted investees that are investment entities



The amendments are effective for annual periods beginning on or after 1 January 2016, with early application is permitted.

The amendment can be accessed on the XRB's website by clicking here.

For more information, please contact your local BDO representative

NEW BDO PUBLICATIONS

The **Audit** section of our website includes a range of publications on IFRS issues. For example:

- **NZ IFRS Industry Issues** contains a high level overview of the impact of new standards on particular industries. Recent NZ IFRS Industry Issues include overviews of the impact of NZ IFRS 15 *Revenue from Contacts with Customers* on the manufacturing; retail; telecommunications, software; media, construction-real estate and professional services uindustries.
- **Summaries on a Page (SOAPs)** contain summaries of NZ IFRS Standards for for-profit entities and PBE Standards for public sector and not-for profit entities currently in effect in New Zealand.
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Also look for the **'BDO International IFRS'** link which includes resources such as:

- **IFRS at a glance** – 'one page' and short summaries of all IFRS standards.
- **IFRS News at a glance** – provides high-level headlines of newly released documents by the IASB and IFRS related announcements by securities regulators.
- **Need to Knows** – updates on major IASB projects and highlights practical implications of forthcoming changes to accounting standards. Recent Need to Knows include IFRS 9 *Financial Instruments - Impairment of Financial Assets* (Dec 2014), IFRS 15 *Revenue from Contracts with Customers* (Aug 2014), IFRS 9 *Financial Instruments* (May 2014), *Hedge Accounting* (IFRS 9 Financial Instruments) (Jan 2014).
- **IFRS in Practice** – practical information about the application of key aspects of IFRS, including industry specific guidance. Recent IFRS in Practice include IFRS 15 *Revenue from Contracts with Customers* (Oct 2014), IAS 7 *Statement of Cash Flows*, Distinguishing between *a business combination and an asset purchase in the extractives industry* (March 2014), IAS 36 *Impairment of Assets* (Dec 2013) and *Common Errors in Financial Statements – Share-based Payment* (Dec 2013).
- **Comment letters on IFRS standard setting** – includes BDO comments on various projects of international standard setters, including Exposure Drafts and other Discussion Papers, when it is considered that the issue is significant to the BDO network and its clients. Latest comment letters include IASB - ED 2014 4 - *Measuring Quoted Investments in Subsidiaries*, IASB - ED 2014 3 - *Recognition of Deferred Tax Assets for Unrealised Losses*; *Joint Ventures and Associates at Fair Value*; IASB ED 2014-02 *Investment Entities: Applying the Consolidation Exception*, IASB ED 2014-01 *Disclosure Initiative and Request for information – Post-implementation Review*: IFRS 3 *Business Combinations.*

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