APRIL 2015
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ASSURANCE ALERT

FINANCIAL REPORTING ACT (2013) – WARNING FOR 'CURRENT ISSUERS' WHO ARE NOT YET REPORTING UNDER THE FINANCIAL MARKET CONDUCTS ACT (2013)

Background

Entities will recall that the new Financial Reporting Act (2013) (FRA 2013) came into effect for periods beginning 1 April 2014 and superseded the previous Financial Reporting Act (1993). There have also been a number of consequential amendments made to various other pieces of legislation, including certain significant amendments to the Companies Act (1993) as a result of the FRA2013.

Previously, the requirement to present both Group and Parent financial statements was included with section 13 of the Financial Reporting Act (1993). However this has since been relocated to section 202 of the (revised) Companies Act (1993), requiring that only Group financial statements need to be prepared

This distinction is important to note for those entities that are 'current issuers' under the Securities Act (1978) who are not (yet) reporting under the Financial Markets Conduct Act (2013), and how this interacts with the transitional provisions of the FRA 2013.

Entities will also recall that that most 'current issuers' have a phased in application/transition to the Financial Markets Conduct Act (2013), providing they are a 'financial market conduct reporting entity' under the act – with the latest date for application being 1 December 2016. Further information on when a 'financial market conduct reporting entity' becomes subject to the Financial Markets Conduct Act (2013) can be found directly on the FMA website here.

Transitional requirements of the Financial Reporting Act (2013)

The transitional provisions of section 55 of FRA 2013 requires that all 'current issuers' that are not yet reporting under the Financial Markets Conduct Act (2013) must continue to report under the Financial Reporting Act (1993), and accordingly the directors of these entities are also required to comply with the Financial Reporting Act (1993).

Therefore, depending on **when** a 'current issuer' begins to report under the Financial Markets Conduct Act (2013), will ultimately determine which Financial Reporting Act (i.e. either the 1993 version or the 2013 version) the entity will need to apply.

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'Current issuer' IS reporting under the Financial Markets Conduct Act (2013)	Prepare financial statements in accordance with the requirements of the Financial Reporting Act (2013): • No requirement to prepare Parent financial statements in addition to Group financial statements (per section 202 of the revised Companies Act (1993)
'Current issuer' IS NOT reporting under the Financial Markets Conduct Act (2013)	Prepare financial statements in accordance with the requirements of the Financial Reporting Act (1993) • Has a requirement to **prepare both Parent and Group financial statements** (per section 13 of the Financial Reporting Act (1993) – note section 202 of the revised Companies Act (1993) does not supersede this requirement of the Financial Reporting Act 1993).

Accordingly for annual periods ending on 31 March 2015 and thereafter, affected entities will need to be very clear as to which piece(s) of legislation they are preparing the financial statements in compliance with in the Basis of Preparation section to the financial statements.

For those entities using the transitional provisions of the Financial Reporting Act (2013) (i.e. those not yet reporting under the Financial Markets Conduct Act (2013)) it is recommended that reference would be made to both the transitional provisions under the Financial Reporting Act (2013) and Financial Reporting Act (1993).

Credit Unions

Under Financial Markets Conduct Act 2013, all Credit Unions are deemed a 'specified class' and are considered to be Financial Market Conduct Reporting Entities for reporting dates ending on or after 31 March 2015.

As such, Credit Unions will be reporting (fully) under the Financial Reporting Act (2013) for reporting dates on or after 31 March 2015, and will therefore only be required to present Group financial statements (per section 202 of the revised Companies Act (1993).

Retirement villages

Under the Financial Markets Conduct Act (2013), Retirement Villages are not deemed a 'specified class'. Therefore going forward, unless they meet the definition of a 'Financial Market Conduct Reporting Entity', they will not be reporting under the Financial Markets Conduct Act (2013).

However the transitional provisions of the Financial Reporting Act (2013) per section 55(1)(a)(i) does scope all Retirement Villages (as 'current issuers') into reporting under the Financial Reporting Act (1993) – which would require the preparation of both Group and Parent financial statements - ***unless*** they meet the definition of an operator (per section 55(1)(b)) – ultimately defined in section 5 of the Retirement Village Act (2003).

Given the complexities of the various pieces of legislation involved, it is highly recommended that the governing bodies of affected entities obtain legal opinion to determine and confirm their financial reporting obligations and the specific pieces of legislation applicable.

The significance of this determination should not be underestimated, as the failure to report in accordance with the correct piece(s) of legislation would be seen as a breach of law, with potentially significant financial and disciplinary consequences to both the entity and members of the governing body.

What should affected entities be doing now?

In order to mitigate potential breaches of law through incorrect financial reporting, entities that are unsure as to how the changes in the laws governing current and future financial reporting will affect them are strongly encouraged to obtain legal advice to assist in this determination.

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

NON-LARGE COMPANIES WITH 10 OR MORE SHAREHOLDERS

With the implementation of the Financial Reporting Act 2013 and related amendments to the Companies Act 1993 for annual periods beginning on or after 1 April 2014, all companies that have ten (10) or more shareholders are automatically scoped into financial reporting requirements, regardless of size.

However, non-public and non-large companies (i.e. those New Zealand owned companies that have neither assets of $60 million nor revenues of $30 million; or foreign owned companies that have neither assets of $20 million nor revenues of $10 million) have the option under S207I of the Companies Act 1993 to opt-out of any or all of the following:

i. preparing financial statements;

ii. having the financial statements audited; and

iii. preparing an annual report.

Please note that a non-large company will be unable to exercise the above opt-out provisions if its constitution expressly prohibits the application of the Companies Act 1993 S207I.

In relation to the opt-out provisions, it should be noted that:

- The opt-out provision(s) must be adopted annually.
- For the opt-out provisions to be valid for an annual period, at least 95% of voting shareholders must approve the opt-out provision(s) during the opting period.

The opting period is defined in Companies Act 1993 S207H as the period from the start of the accounting period until the close of the earliest of either:

- the date that is 6 months after the start of the accounting period;
- the date of the annual meeting to be held in the accounting period; or
- in the case of an accounting period that is shorter than 6 months (as a result of the date of the registration of the company or a change of the balance date of the company), the balance date of the period.

If the opt-out provisions(s) are not approved by 95% of voting shareholders before the earliest of the above dates, the company with 10 or more shareholders will have to prepare audited financial statements and an annual report.

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

ATTENTION LARGE FOREIGN COMPANIES DOING BUSINESS IN NEW ZEALAND

The default position in New Zealand law requires that all entities that are required by statute to file financial statements with Companies Office must file audited New Zealand Generally Accepted Accounting Practice (NZ GAAP) compliant financial statements.

This is obviously onerous for foreign entities that are not required to report under NZ GAAP in their local jurisdictions and/or do not have an audit requirement.

Prior to annual periods commencing on 1 April 2014, the Registrar of Companies had provided "blanket" exemptions for most foreign entities whereby these entities were able to file their foreign jurisdiction compliant financial statements. If these entities did not require an audit under local requirements, they were generally exempted from having to file audited foreign financial statements.

For annual periods beginning on or after 1 April 2014, when the amended Companies Act 1993 comes into effect, these "blanket" exemptions have fallen away.

Instead, the amended Companies Act 1993 includes an exemption per **S203** for recognition of financial reporting requirements of overseas companies. Per S203 the Registrar of Companies can provide a notice to a foreign company in respect of the acceptability/applicability of their local jurisdiction financial statements so long as the Registrar is satisfied that:

- The foreign entity's local statutory requirements are substantially the same as the New Zealand Companies Act 1993 and
- Foreign financial reporting requirements are substantially equivalent to New Zeeland financial reporting requirements.

The onus is on the foreign entity to apply for a S203 notice. (At the date of writing this article, no S203 notices have been issued by Companies Office.)

If a S203 notice is not issued, the Registrar does have the power to grant specific exemptions to overseas companies under **S207L** of (amended) Companies Act 1993. These specific exemptions relate to:

- S201 – the preparation of financial statements
- S202 – the preparation of group financial statements
- S207 – the audit of financial statements
- S207E – the registration of financial statements

All of the above exemptions are unique exemptions and **must be applied for by the entity concerned.**

It is **highly recommended** entities make applications for exemption under S207L as early as possible due to the expected volume of applications likely to be made. (Exemptions will need to be made well in advance of filing deadlines to ensure that the New Zealand specific requirements for a particular reporting period are exempted).

It should be noted that the above exemptions are not applicable to entities which are reporting entities under the Financial Markets Conduct Act 2013. These entities need to apply for any applicable exemptions from the Financial Markets Authority.

It is highly recommended that due to the large number of significant changes in legislative reporting requirements for annual periods beginning on or after 1 April 2014, all clients obtain legal advice in relation to the application thereof to ensure compliance with New Zealand statute.

- **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: (8) CAPITALISING BORROWING COSTS

As highlighted in the December 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 expense all borrowing costs as they are incurred, rather than assess them for (partial) capitalisation to 'qualifying assets' as defined by NZ IAS 23 *Borrowing Costs*.

Overview of the requirements of NZ IFRS (Diff Rep) and NZ IFRS (RDR)
Paragraph NZ 4.1 of NZ IAS 23 (Diff Rep) *Borrowing Costs* provides entities with the option not to account for borrowing costs in accordance with the standard, and instead recognise them as an expense in the period in which they are incurred

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 capitalise all borrowing costs that are directly attributable to the acquisition, construction or production of a *qualifying* asset.

Application of NZ IAS 23
(i) Borrowing costs – definition and examples

NZ IAS 23 requires that all directly attributable borrowing costs attributable to the acquisition, construction or production of a qualifying asset(s) form part of the cost of that asset(s). Borrowing costs include **both:**

- Those incurred in relation to **specific** borrowings entered into to fund production of the *qualifying asset(s)*.
  Note that this is net of any investment income earned from such borrowings during the period from when the funds were obtained and subsequently used on expenditure relating to the production of the *qualifying* asset.
- Those related to other **general** borrowings that would have otherwise been repaid had the entity not acquired the *qualifying asset(s).*

Borrowing costs are those cost incurred in relation with the borrowing of funds, and can include:

- Interest expense (calculated using the effective interest method)
- Finance charges in respect of finance leases
- Exchange differences arising from foreign currency borrowings (to the extent that they are regarded as an adjustment to interest costs).

Borrowing costs may also include:

- Adjustments to the carrying amounts of borrowings resulting from a re-estimation of expected cash flows (carried out in accordance with NZ IAS 39 *Financial Instruments: Recognition and Measurement)*
- Accruals in relation to interest rate swap (IRS) derivatives that are not part of a hedging relationship under NZ IAS 39 (i.e. IRSs entered into as *economic hedges*) – however fair value movements in such instruments do not represent borrowing costs.
- Distributions (dividends) paid in relation to instruments classified as liabilities for accounting purposes in accordance with NZ IAS 32 *Financial Instruments: Presentation* (e.g. dividends paid on certain classes of preference shares).

All borrowing costs should be capitalised at their pre-tax amounts – note that capitalised borrowing costs may give rise to deferred tax in accordance with NZ IAS 12 *Income Tax*, depending on the specific tax law applicable in various jurisdictions.

However, the unwinding of any discount (i.e. 'imputed interest') on non-financial items, such as long-term provisions, are not considered to be *borrowing costs* that should be capitalised to *qualifying assets*.

(ii) Qualifying assets – definition and examples

A qualifying asset is an asset that necessarily takes a **substantial period of time** to get ready for its intended use or sale. It should be noted that NZ IAS 23 does not provided any further guidance in terms of *what a substantial period of time* is, therefore this will be a matter of management judgement on a case-by-case basis considering all facts and circumstances. In practice, a *substantial period of time* is usually considered to be well in excess of six months.

Examples of assets that could potential meet (or not meet) the definition of a qualifying asset are listed below (note, these are subject to specific facts and circumstances):

Assets that could be *qualifying assets*	Assets that would likely not be *qualifying assets*
► Inventories that take a long time to produce (e.g. Whiskey, wine, property developments) ► Plant and machinery under construction (or refurbishment) ► Investment properties under construction (or refurbishment) ► Intangible assets under construction (including development costs being capitalised in relation to long-term projects)	► Inventories (or any other asset) produced over a short period of time ► Investments in subsidiaries, joint arrangements, and/or associates ► Financial assets ► Any asset ready for intended use when (or shortly after) it is acquired ► Any asset where the substantial period of time required to get the asset ready for intended use is due to the entity's inefficiencies in its production processes.

(iii) Commencement, suspension, and cessation of the capitalisation of borrowing costs

Commencement of the capitalisation of borrowing costs begins at *commencement* date, which is defined as the date where **all** of the following occur:

- The entity incurs expenditures for the qualifying asset (including any technical or administrative work that is required to be undertaken before production begins – i.e. obtaining permits etc.)
- The entity incurs borrowing costs, and
- The entity undertakes activities that are necessary to prepare the qualifying asset for its intended use (or sale).

Borrowing costs cease to be capitalised when **substantially all** the activities necessary to prepare the qualifying asset for its intended use (or sale) are complete. This includes ceasing capitalisation of borrowing costs in relation to parts/stages of qualifying assets that are capable of being used once they are individually completed whilst production of the remaining parts/stages of the qualifying asset continues.

If at any point during the production process, active development of the qualifying asset is suspended during **extended periods**, the capitalisation of borrowings costs to the qualifying asset must also be suspended (e.g. where production stops due to sourcing of specialised parts).

It should again be noted that NZ IAS 23 does not provided any further guidance in terms of what an *extended period* is, therefore this will be a matter of management judgement on a case-by-case basis considering all facts and circumstances.

Circumstances where an extended period would not occur (and therefore capitalisation of borrowing costs could still occur) would potentially be temporary delays due to:

- External events (e.g. flood)
- Technical or legal obstacles that are common in the process or jurisdiction
- Administrative or technical work being required to be undertaken.

(iv) Capitalising borrowing costs – at what rate?

NZ IAS 23 provides little practical guidance or illustrative examples as to how an entity is to capitalise borrowing costs to qualifying assets, other than the specific requirements within the main body of the standard.

In terms of **specific** borrowings, NZ IAS 23 paragraph 12 is clear that an entity capitalises **all** borrowing costs incurred (less any investment income earned on those funds – as detailed previously).

In terms of **general** borrowings, NZ IAS 23 paragraph 14 requires that borrowing costs eligible for capitalisation to *qualifying assets* are determined by applying a *capitalisation rate* to the expenditures on that asset.

The *capitalisation rate* is equal to the weighted average of the borrowing costs applicable to **general** borrowings that were outstanding during the period (i.e. excluding **specific** borrowings). It should be noted that the calculation of general borrowing costs can be challenging.

It should also be noted that as a sense-check, the amount of capitalised borrowing costs during a period must not exceed the amount of borrowing costs actually incurred during the period.

Summary of the overall impact

This change will only impact those Tier 3 for-profit entities that both:

- Have qualifying assets, and
- Have elected to apply the previous NZ IAS 23 (Diff Rep) exemption.

Going forward, the impact for affected entities will be:

- Increases in accounting net profit (as a portion of borrowing costs are capitalised)
- Potential deferred tax implications (depending on specific tax law as it relates to capitalised borrowing cost)
- Changes in the presentation of statement of cash flows (i.e. capitalised borrowing costs must be presented within investing activities)
- Disclosure of capitalised borrowing costs during the period.

What should affected entities be doing now?

- Identify any potential *qualifying assets*
- Identify and segregate their specific and general borrowing costs
- Isolate borrowing costs related to specific borrowings
- Determine the capitalisation rate(s) for general borrowings.

The significance of this change should not be underestimated, especially those affected entities that have significant amounts of qualifying assets. 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).

► **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: (9) MEASUREMENT OF BIOLOGICAL ASSETS AND AGRICULTURAL PRODUCE AT FAIR VALUE LESS COSTS TO SELL, AND (10) REMOVAL OF IRD NATIONAL STANDARD COSTS FOR LIVESTOCK.

As highlighted above, 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 measure each class of biological assets and agricultural produce at cost (including the removal of the option to use IRD national standard costs for livestock).

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

Paragraph NZ 4.1 of NZ IAS 41 (Diff Rep) *Agriculture* provides entities with the option to, on a class-by-class basis, measure biological assets and agricultural produce at either cost, or fair value less costs to sell.

In addition, those entities with *livestock* were permitted to use national standard costs issued by the Inland Revenue Department as a proxy for the cost of a class of livestock.

Under NZ IFRS (RDR) both these options have been removed, and therefore Tier 3 entities that will be required to transition to Tier 2 will be required to measure all classes of biological assets and all classes of agricultural produce **at fair value less cost to sell.**

Application of NZ IAS 41 – fair value less cost to sell

The definition and specific requirements of *fair value* measurement under NZ IFRS (RDR) are found within NZ IFRS 13 *Fair Value Measurement*.

Fair value represents the price that would be received to sell an asset (or paid to transfer a liability) in an orderly transaction between market participants at the measurement date (defined by NZ IFRS 13 paragraph 9).

Costs to sell are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes (defined by NZ IAS 41 paragraph 5).

NZ IFRS 13 is a comprehensive standard and includes a number of relevant considerations for agricultural entities to consider, including (but not limited to):

- Identifying a *market* participant
- Identifying the market (i.e. whether it is the *principal market*, or where there is no *principal market* the *most advantageous market*)
- Determining whether a transaction is *orderly*
- Determining highest-and-best-use.

Al of these considerations (and many others) are comprehensively detailed in BDO's international publication *Need to Know* – IFRS 13 *Fair Value Measurement* –available **here.**

Summary of the overall impact

This change will only impact those Tier 3 for-profit entities that both:

- Have agriculture assets, and
- Have elected to apply the previous NZ IAS 23 (Diff Rep) exemptions to measure certain classes of agriculture assets at cost, and or used IRD standard costs for livestock.

For such affected entities, agricultural assets will need to begin to be measured at fair value less cost to sell in accordance with NZ IAS 41 and NZ IFRS 13.

What should affected entities be doing now?

Affected entities will need to begin determining opening fair value positions for all agricultural and biological assets as at the date of transition to NZ IFRS (RDR), so that comparative amounts under NZ IFRS (RDR) can be prepared for the year in which NZ IFRS (RDR) is adopted for the first time.

The significance of this change should not be underestimated, and therefore 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**

NEW BDO PUBLICATIONS

The **Audit** section of our website includes a range of publications on accounting standards 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 industries.
- **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 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*.

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

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