BDO Backing precision

www.bdo.co.nz

October 2015

ARE YOUR FINANCIAL STATEMENTS OVERWEIGHT?

The issue of 'decluttering' financial statements has arisen as a result of the International Accounting Standards Board's (IASB's) disclosure initiative project that aims to improve disclosure requirements in IFRS financial statements.

The reality is that fear of regulator scrutiny, and preparer and auditor complacency has resulted in the financial statements of many New Zealand entities being 'overweight'.

THE HUMAN CONDITION

Many annual reports seem to be suffering from 'middle aged spread' at the moment. Too much fat and too little lean muscle are affecting their ability to act efficiently and effectively. Besides having to prepare financial statements for compliance reasons, the financial statements are intended to concisely convey to the various users an accurate picture of the entity to allow them to make decisions. If there is too much fat detracting from the underlying muscle, users will have a hard time understanding the financial statements.

WHAT DO OVERWEIGHT FINANCIAL STATEMENTS LOOK LIKE?

The following add weight to the financial statements, with little benefit for the user:

- Too much useless information about immaterial items that are not relevant to users (e.g. small profit or loss item disclosures, detailed reconciliations of PPE where movements are minimal during the period)
- Accounting policies describing transactions and events that do not occur in the entity (e.g. hedging, certain types of financial instruments, consolidations, equity accounting, joint arrangements, revaluing assets, etc.)
- Accounting policies that are so boilerplate that users are unable to really understand how transactions are recognised and measured (e.g. revenue recognition)
- Information about sources of estimation uncertainty that is so boilerplate it tells the user nothing about the specific assumptions made in the estimate that could impact the estimation of the carrying amount of assets and liabilities in the next financial year
- Providing information about estimates that are not significant to the financial statements (e.g. employee leave provisions), or will not result in a material adjustment to assets and liabilities in the next financial year (e.g. share-based payment estimations)
- Boilerplate information about judgements made that do not explain, in plain English, what the judgement was (e.g. choice of accounting policy A instead of accounting policy B because …)
- Laundry lists of detailed information about standards that are only effective in future years which are unlikely to have a material impact on the entity, or indeed could never vaguely apply

Continued on next page.

IN THIS ISSUE

- ARE YOUR FINANCIAL STATEMENTS OVERWEIGHT
- RELIEF FOR WHOLLY-OWNED ENTITIES WITH NEW ZEALAND REPORTING OBLIGATIONS
- CORPORATE GOVERNANCE HANDBOOK RELEASED
- BELOW-MARKET AND INTEREST-FREE LOANS TO EMPLOYEES
- CHANGES IN THE PIPELINE FOR THE NEW REVENUE STANDARD NZ IFRS 15 TO HELP CLARIFY APPLICATION ISSUES
- NEW BDO PUBLICATIONS

Get social with us

to the entity because they do not operate in a particular industry or engage in the relevant types of transactions

- Comparative information carried forward which has no relevance to the current period financial statements (e.g. including detailed disclosures for a business combination that occurred two years ago or a share-based payment that was granted three years ago)
- Too much narrative when a tabular format of disclosure would enable the user to better understand disclosures
- Technical accounting or other jargon which is not explained, rather than using plain English wherever possible
- Notes about the most important transactions and events buried in the financial statements, making them hard to find.

WHAT ABOUT MATERIALITY?

While most preparers, users and auditors understand quantitative materiality in the context of recognition and measurement, it is more difficult to apply materiality to disclosures because some disclosures may be qualitatively, rather than quantitatively, material.

Many preparers would rather include all disclosures (the 'kitchen sink' mentality) because:

- They cannot be 'rapped over the knuckles' by the Financial Markets Authority for lack of disclosure
- Even if the item is not material this year, including it will remind us that we need it next year if it becomes material
- It takes too long to negotiate with the auditor what is material and what is not.

However, failing to think about, and apply materiality to disclosures is one of the major reasons for financial statements being overweight.

The good news is that the IASB have undertaken to issue an Exposure Draft of a *Practice Statement Application of Materiality to Financial Statements* to provide guidance on applying materiality when disclosing information. We expect that it will be issued before the end of 2015. We will update you in future editions of Accounting Alert when this Exposure Draft is issued.

START THINKING AHEAD

While many listed entities may have completed, or be nearing completion of their 30 June 2015 financial report, private companies and other types of entities may still be in the process of drafting accounts and have the opportunity to start 'going on diet'. This means that there are simple steps you can take to start shedding pages and unnecessary disclosures in your financial statements.

Even if you decide that it is too late to start now, we urge you to start thinking about the process and start planning to tone up your 2016 financial statements. Taking note of the points above will go a long way to reducing the clutter.

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

RELIEF FOR WHOLLY-OWNED ENTITIES WITH NEW ZEALAND REPORTING OBLIGATIONS

The New Zealand Registrar of Companies has provided relief from New Zealand financial reporting and audit requirements to qualifying wholly-owned Australian subsidiaries through the *Companies Act* (*Overseas Incorporated Companies—Australian Wholly-owned Entities*) *Exemption Notice 2015* ("exemption notice") available here.

This exemption notice **exempts certain Australian subsidiaries** from their reporting and audit obligations under the amended New Zealand Companies Act 1993, which came into effect for periods beginning on or after 1 April 2014.

The change provides much needed relief from the reporting obligations of Australian companies with New Zealand branch operations under the new legislation.

This exemption notice has immediate effect, and will expire on 31 July 2020. The exemption applies to accounting periods beginning on or after 18 June 2015. It also applies to accounting periods that commenced before the exemption was granted (e.g. 31 March 2015 year ends) provided that the financial statements were not required to be registered or completed before 18 June 2015.

FILING REQUIREMENTS

Generally, under New Zealand reporting requirements, 'large' overseas companies (either NZ$10m of revenue or NZ$20m of assets for current and 2 preceding periods) with branch operations in New Zealand have to prepare and lodge audited financial statements in accordance New Zealand GAAP for the company and its subsidiaries, if any. (For more information on these requirements please refer to the April 2015 and August 2014 editions of Assurance Alert).

The branch (if large) also needs to file audited NZ GAAP financial statements.

The exemption notice, however, now provides relief to **Australian wholly-owned subsidiaries** that:

- Apply Australian Securities and Investment Commission (ASIC) *Class Order 98/1418 Wholly-owned entities* ("Class Order") and
- Lodge their parent's audited consolidated accounts with ASIC to meet their Australian reporting and audit obligations.

Entities that apply the Class Order in Australia will also be exempt from preparing and filing their own audited financial statements in New Zealand in NZ GAAP. (I.e. these qualifying entities will no longer need to prepare another set of accounts for themselves (and any subsidiaries) for the purpose of their New Zealand reporting obligations.)

Instead, to meet their New Zealand reporting obligations they can file their parent's consolidated Australian GAAP financial statements (lodged for Australian reporting purposes). (This is similar to the relief that was previously provided under the Financial Reporting Act 1993).

Please note that this exemption does not extend to the branch. Branches (if large) must still file audited NZ GAAP compliant financial statements in accordance with the requirements of the Companies Act 1993.

It should also be noted that small Australian proprietary companies with New Zealand branch operations that are not applying the Class Order would still have reporting obligations in New Zealand if they meet the 'large overseas company' thresholds under New Zealand law, which are different from the size test under Australian law. I.e. this exemption notice does not apply to Australian entities that do not apply the Class Order.

REQUIREMENTS TO COMPLY WITH THE EXEMPTION NOTICE:

To apply the exemption notice, the following conditions must be satisfied:

- The parent's consolidated financial statements must comply with applicable Australian accounting standards
- The parent's consolidated financial statements must be audited by a qualified auditor in accordance with applicable Australian auditing standards, and
- Within 20 working days after the parent's consolidated financial statements are required to be signed (in Australia), the **following documents must be delivered to the New Zealand Registrar** by the directors of the exempt Australian subsidiary:
  - The parent's consolidated financial statements, together with the auditor's report on those statements
  - A memorandum signed by the directors with the details specified in the Exemption Notice (item 7(c)), and
  - A copy of Class Order 98/1418.

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

CORPORATE GOVERNANCE HANDBOOK RELEASED

The volatility of financial markets over recent years, coupled with high profile corporate failures and a number of court cases outlining the responsibilities of directors, has increased regulator, investor and public focus on corporate governance.

The Financial Markets Authority ("the FMA") has recently released a handbook, *Corporate Governance in New Zealand: Principles and Guidelines* ("the Handbook"), that provides an overview of the principles of good corporate governance and guidelines on how to apply those principles.

The Handbook is intended for those entities that have an economic impact in New Zealand, or are accountable to the public, such as FMC reporting entities and issuers. However, the principles that it outlines apply to a broad range of entities and the guidance that it provides can be adapted to suit the needs of smaller, privately-held entities. For those reasons, directors of companies, and those in governance roles in other organisations, should familiarise themselves with the Handbook and seek to apply its corporate governance principles in their businesses and organisations.

The Handbook's nine corporate governance principles, and a brief overview of the guidelines provided in relation to each of them, are outlined in the table below.

PRINCIPLE	PRINCIPLE STATEMENT	GUIDELINES
Principle 1: **Ethical standards**	Directors should set high standards of ethical behaviour, model this behaviour, and hold management accountable for delivering these standards throughout the organisation.	▶ The board of every entity should adopt a written code of ethics that is a meaningful statement of its core values. ▶ The code should include processes for recording and evaluating compliance with the code and measures for dealing with breaches of the code. ▶ Every entity should communicate its code of ethics to its employees and provide appropriate employee training and procedures. ▶ Every board should have a system to implement and review the entity's code of ethics. ▶ The board should monitor adherence to the code and hold directors, executives, and other personnel accountable for acting ethically at all times. ▶ Every entity should publish its code of ethics.
Principle 2: **Board composition and performance**	To ensure an effective board, there should be a balance of independence, skills, knowledge, experience and perspectives.	▶ Every issuer's board should have an appropriate balance of executive and non-executive directors, and should include directors who meet formal criteria for "independent directors". ▶ All directors should (except as permitted by law and disclosed to shareholders), act in the best interests of the entity. ▶ Every board should have a formal charter that sets out the responsibilities and roles of the board and directors. ▶ The chairperson of a publicly owned entity should be independent. ▶ Directors should be selected and appointed through rigorous, formal processes designed to give the board a range of relevant skills and experience. ▶ The board should have rigorous, formal processes for evaluating its performance.

PRINCIPLE	PRINCIPLE STATEMENT	GUIDELINES
Principle 3: **Board committees**	The board should use committees where this will enhance its effectiveness in key areas, while still retaining board responsibility.	▶ Every board committee should have a clear, formal charter that sets out its role and delegated responsibilities while safeguarding the ultimate decision-making authority of the entire board. ▶ Proceedings of committees should be reported back to the board to allow other directors to question committee members. ▶ Each publicly owned company should establish an audit committee with responsibilities to recommend the appointment of external auditors, oversee all aspects of the entity-audit firm relationship and promote integrity and transparency in financial reporting. Audit committees should comprise all non-executive directors (a majority of whom are independent), at least one director who is a qualified accountant or has another recognised form of financial expertise and a chairperson who is independent (and who is not the chairperson of the board).
Principle 4: **Reporting and disclosure**	The board should demand integrity in financial reporting and in the timeliness and balance of corporate disclosures.	▶ All boards should have a rigorous process for ensuring the quality and integrity of financial statements. ▶ Financial reporting and annual reports should, in addition to all information required by law, include sufficient, meaningful information to enable investors and stakeholders to be well informed. ▶ All boards must maintain an effective system of internal control for reliable financial reporting and accounting records. ▶ Each listed entity should have a clear and robust written internal process for compliance with the continuous disclosure regime.
Principle 5: **Remuneration**	The remuneration of directors and executives should be transparent, fair and reasonable.	▶ The board should have a clear policy for setting remuneration of executives (including executive directors) and non-executive directors at levels that are fair and reasonable in a competitive market for the skills, knowledge and experience required. ▶ Publicly owned entities should publish their remuneration policies on their websites. ▶ Executive (including executive director) remuneration packages should include an element that is dependent on entity and individual performance.
Principle 6: **Risk management**	Directors should have a sound understanding of the key risks faced by the business. The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.	▶ The board should require the entity to have rigorous processes for risk management and internal controls. ▶ The board should receive and review regular reports on the operation of the risk management framework and internal control processes, including any developments in relation to key risks. ▶ Boards of issuers should report at least annually to investors and stakeholders on risk identification, risk management and relevant internal controls.
Principle 7: **Auditors**	The board should ensure the quality and independence of the external audit process.	▶ The board should fully inform itself on the responsibilities of external auditors and be rigorous in its selection of auditors on the basis of professional merit. ▶ The board should satisfy itself that there is no relationship that could compromise the auditor's independence. The board should require confirmation of this from the auditor. ▶ The board should facilitate regular and full dialogue among its audit committee, the external auditors and management. ▶ The board should ensure the disclosure of appropriate information about fees paid to auditors – for more information on this, see page 5 of the September 2015 Accounting Alert, which is available here.
Principle 8: **Shareholder relations**	The board should foster constructive relationships with shareholders that encourage them to engage with the entity.	The FMA encourages widely-held entities to: ▶ Have clear published policies for shareholder relations and regularly review practices, aiming to clearly communicate the goals, strategies and performance of the entity. ▶ Maintain an up-to-date website, providing information of use to shareholders. ▶ Encourage shareholders to take part in annual and special meetings by holding these in locations, and at times, that are convenient to shareholders and by providing clear and meaningful information about the business to be conducted at the meetings. ▶ Facilitate questioning of external auditors by shareholders during the annual meeting.
Principle 9: **Stakeholder interests**	The board should respect the interests of stakeholders taking into account the entity's ownership type and its fundamental purpose.	▶ The board should have clear policies for the entity's relationships with significant stakeholders. ▶ Public sector entities should report at least annually to inform the public of their activities and performance, including how they have served the interests of their stakeholders.

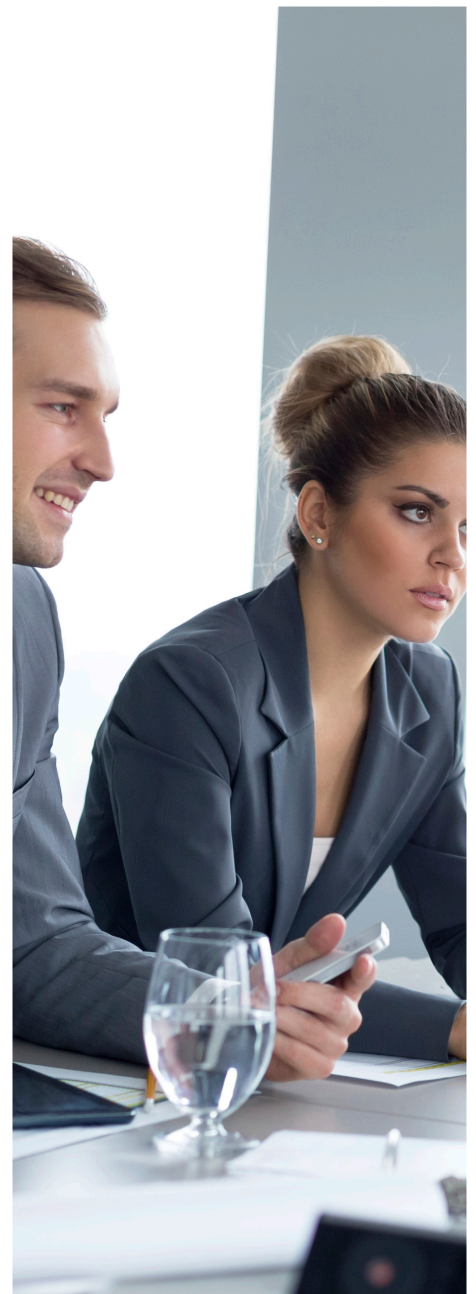
In addition to applying the guidance in the Handbook, listed entities must also comply with the corporate governance requirements of the NZX Listing Rules.

The information in the table above provides only a high level summary of the Handbook. A full copy of the FMA handbook is available **here**.

As outlined in principle 4 of the Handbook, if you are a director, one of your key responsibilities is to ensure that the financial statements fairly present the company's financial position and performance. The BDO resource *Non-Executive Directors: Questions you need to ask* (**available here**) provides questions that a non-executive director should consider asking of executive management (and the auditor, if one is appointed) in order to gain comfort that accounting issues have been appropriately dealt with.

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

BELOW-MARKET AND INTEREST-FREE LOANS TO EMPLOYEES



Following on from last month's article on below-market and interest free loans, a question has arisen on how to treat such loans with employee counterparties.

Must the entity recognise the difference between the calculated fair value and the consideration given as an employee benefit expense in profit or loss under NZ IAS 19 *Employee Benefits*; or can an asset be recognised?

Well the answer is, it depends!

Loans granted to employees are financial instruments within the scope of NZ IAS 39 *Financial Instruments: Recognition and Measurement*. Therefore on initial recognition they are required to be measured at fair value.

If the (favourable) loans have been granted at below-market interest rates or interest free, then the employees are obtaining additional benefits from the entity.

These additional benefits will most likely meet the definition of employee benefits in NZ IAS 19, although NZ IAS 19 does not directly address how to account for this benefit.

If the favourable loan terms are not dependent on continued employment, we believe that there is a rebuttable presumption that the benefit obtained relates to past services, and thus should be recognised in profit or loss immediately.

However, if the benefit relates to services to be rendered in future periods (for e.g. if the employee will be required to pay "catch-up" market interest on the loan if the employee leaves the employ of the entity or it is a bonus for future services), then there is an argument to treat the benefit as a prepayment and expense it in the period in which the services are rendered. Care will need to be taken though to ensure that if the services are going to be rendered more than 12 months into the future, that the benefit is treated as a long-term benefit under NZ IAS 19.

The loan itself will have interest imputed thereon at the market rate up and until settlement.

It should also be noted that any loans made to key management personnel (including directors) are related party transactions under NZ IAS 24 *Related Party Disclosures* and disclosures thereof will be required, irrespective of whether the interest rates are favourable or not.

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

CHANGES IN THE PIPELINE FOR THE NEW REVENUE STANDARD NZ IFRS 15 TO HELP CLARIFY APPLICATION ISSUES

As a result of implementation issues identified by the Transition Resource Group (TRG) for the new revenue standard, the New Zealand Accounting Standards Board (NZASB) recently issued exposure draft IASB ED/2015/6 *Clarifications to IFRS 15* (the ED) that proposes additional guidance and illustrative examples on:

- Identifying performance obligations
- Principal vs agent considerations, and
- Licensing.

The ED is also proposing additional practical expedients on transitions to NZ IFRS 15.

Identifying performance obligations

NZ IFRS 15 requires revenue recognition for each separate performance obligation. A promise to transfer to a customer a good or service that is 'distinct' is a separate performance obligation.

To clarify the concept of a 'distinct' good or service, the ED is proposing to amend the existing examples 10, 11 and 12, and adding additional scenarios for installation services, multiple items and equipment/consumables.

Principal vs agent considerations

NZ IFRS 15, as originally issued, included significantly more guidance to determine whether you are acting as principal or agent in a contract with a customer. However, due to the fact that the assessment of the transfer of control for items purchased online is more complex in comparison to tangible assets, the ED is proposing to also clarify that the principal obtains control of the good or service prior to transferring it to the customer.

Licensing

When licenses are distinct from other goods or services identified in a contract, NZ IFRS 15 requires that we determine whether the license transfers to the customer over time (right to use intellectual property) or at a point in time (right to access intellectual property).

With a promise to provide access to intellectual property (IP), the contract would normally require, or the customer would reasonably expect, that the entity will undertake activities that significantly affect the IP. The ED proposes additional guidance to determine when the entity's activities will significantly affect the IP, i.e. when:

- The activities are expected to change the form or functionality, or
- The ability of the customer to derive benefits from the intellectual property is dependent on those activities.

The additional guidance clarifies that if the IP has significant standalone functionality, the IP would not be significantly affected by the entity's activities unless those activities change the functionality.

The ED also proposes to amend examples 54 and 56-59.

Further guidance is also proposed on sales-based or usage-based royalties and examples 60 and 61 are amended.

Practical expedients

The TRG raised concerns about the potential challenges in applying full retrospective restatement to certain aspects of the NZ IFRS. As a result, the ED is also proposing two additional practical expedients on transition to NZ IFRS 15 as follows:

- To permit entities to use hindsight to identify satisfied and unsatisfied performance obligations in a contract that was modified before the beginning of the earliest period presented, and
- To permit entities using the full retrospective method not to apply NZ IFRS 15 retrospectively to contracts that were complete at the beginning of the earliest period presented.

Comments due

Comments are due to the NZASB by 2 October 2015 and the International Accounting Standards Board by 28 October 2015.

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

NEW BDO PUBLICATIONS

The **Audit** section of our website (www.bdo.co.nz/audit) 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.

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 – Classification and Measurement* (April 2015), 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 – Transition*; 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 2015-2 Effective Date of IFRS 15, ED IAS ED 2015-1 *Classification of Liabilities, Basel Committee on Banking Supervision – Guidance on accounting for expected credit losses*, IASB ED 2014-06 *Disclosure Initiative*, IASB - ED 2014-4 *Measuring Quoted Investments in Subsidiaries*, IASB - ED 2014-3 *Recognition of Deferred Tax Assets for Unrealised Losse*s.

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

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact your local BDO member firm to discuss these matters in the context of your particular circumstances. BDO New Zealand Ltd, its partners, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it. BDO New Zealand Ltd, a New Zealand limited liability company, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO New Zealand is a national association of independent member firms which operate as separate legal entities.

For more info visit www.bdo.co.nz

BDO is the brand name for the BDO network and for each of the BDO Member Firms.

KEY CONTACTS

NORTHLAND
Mahmood Khan
T: +64 9 407 7250
Adelle Allbon
T: +64 9 430 0471

AUCKLAND
David O'Connor
Andrew Sloman
Chris Neves
Graeme Lynch
Wayne Monteith
Blair Stanley
T: +64 9 379 2950

WAIKATO
Bernard Lamusse
T: +64 7 839 2106

TAURANGA
Fraser Lellman
T: +64 7 571-6280

ROTORUA
Judith Stanway
T: +64 7 347 9087

GISBORNE
Chris Torrie
Daryl Keast
T: +64 6 869 1400

TARANAKI
Steve Waite
T: +64 6 759 9034

CENTRAL NORTH ISLAND
Glenn Fan-Robertson
T: +64 6 835 3364
Matt Coulter
T: +64 6 872 9817

WELLINGTON
Henry McClintock
Mark Bewley
T: +64 4 472 5850

CHRISTCHURCH
Michael Rondel
Warren Johnstone
T: +64 3 379 5155

INVERCARGILL
Greg Thomas
T: +64 3 218 2959