THE NEW ZEALAND ACCOUNTING ENVIRONMENT

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PART 1

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CHAPTER 1
AN OVERVIEW OF THE NEW ZEALAND EXTERNAL REPORTING ENVIRONMENT

LEARNING OBJECTIVES

Upon completing this chapter, readers should be able to:

LO1 indicate the scope of regulation relating to New Zealand external financial reporting;

LO2 explain the general functions of the Accounting Standards Review Board, the Financial Reporting Standards Board, the New Zealand Securities Commission and the New Zealand Exchange;

LO3 explain why New Zealand adopted accounting standards issued by the IASB and discuss this body's direct relevance to New Zealand accounting standard setting;

LO4 describe the structure of the IASB;

LO5 formulate the purpose of conceptual framework projects, define the elements of accounting and recall their respective recognition criteria;

LO6 explain the implications of New Zealand's decision to adopt accounting standards issued by the IASB;

LO7 describe cultural differences and the impact these differences might have on the harmonisation of accounting standards;

LO8 describe the use and role of audit reports; and

LO9 discuss the fact that the practice of financial accounting is quite heavily regulated within New Zealand and evaluate some of the arguments for and against the regulation of financial accounting.

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INTRODUCTION TO FINANCIAL ACCOUNTING

This book focuses on financial accounting, which can be considered a process involving the collection and processing of financial information to meet the decision-making needs of parties *external* to an organisation. Financial accounting can be contrasted with management accounting. Management accounting focuses on providing information for decision making by parties *within* the organisation (that is, for *internal* as opposed to *external* users) and it is largely unregulated. Financial accounting, by contrast, is subject to many regulations.

Because management accounting relates to the provision of information for parties within an organisation, the view is taken that there is no need to protect the information needs or rights of these parties as, being insiders, they can relatively easily access the information they require. By contrast, it is maintained that the information rights of outsiders, who are not involved in the day-to-day operations of an organisation (such as shareholders of a listed company), must be protected. Because financial reports prepared for external parties are often used as a source of information for parties contemplating transferring resources to an organisation, it is arguably important that certain rules be put in place to govern how the information should be compiled. That is, the adoption of a 'pro-regulation' perspective to protect the interests of parties external to a firm requires some regulation relating to accounting information. (Pro-regulation and 'free-market' perspectives will be considered in more detail towards the end of this chapter.)

1.1 USERS' DEMAND FOR GENERAL PURPOSE FINANCIAL STATEMENTS

External financial reports may be used by an array of user groups for many purposes. The New Zealand 'Framework for the Preparation and Presentation of Financial Statements' (NZ Framework) was granted authoritative support by the Accounting Standards Review Board (ASRB) in June 2005. As this chapter will set out in some detail, under the new international harmonisation program the NZ Framework, which is based closely on the IASB Framework of the same name, supersedes the New Zealand 'Statement of Concepts for General Purpose Financial Reporting' (Statement of Concepts) and now constitutes New Zealand's Conceptual Framework.

The NZ Framework states that users of external financial reports may be defined as including: 'present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public' (para. 9). Some parties with an interest in the financial affairs of an entity might be in a position to successfully demand reports that satisfy their specific information needs. For example, banks might demand, as part of a loan agreement, that a borrowing organisation provide information about its projected cash flows. Such a report would be considered a **special-purpose financial report**—in this case, a report prepared specifically to satisfy the needs of the bank. Other parties with interests in the affairs of an organisation might not have the necessary *power* to demand reports that specifically address their own information requirements, having instead to rely on reports of a *general nature* released by the reporting entity to meet the needs of a broad cross-section of users, such as investors, potential investors, employees, employee groups, creditors, customers, consumer groups, analysts, media, government bodies and lobby groups. These reports are **general purpose financial statements** (as opposed to special purpose financial reports). Such reports would be developed to generally meet the information requirements of a cross-section of shareholders, as well as those of other stakeholder groups such as creditors, employees, government, potential investors and other interest groups. This text concerns itself primarily with general purpose financial reporting.

special-purpose financial report
Report designed to meet the needs of a specific group or to satisfy a specific purpose.

general purpose financial statement
Report that complies with the New Zealand Framework and accounting standards and meets the information needs common to users who are unable to command the preparation of reports tailored to satisfy, specifically, all their information needs.

An example of a general purpose financial report would be the financial statements and supporting notes included within an annual report presented to shareholders at a company's annual general meeting. This book focuses on general purpose financial reporting practices that would typically be used by private-sector profit-seeking entities. In recent years the New Zealand government and government departments have adopted the kind of accounting procedures used by business entities in the private sector. Much of the discussion that follows can be applied to government entities, particularly government trading enterprises that compete directly with private-sector firms. Nevertheless, there continue to be some differences between the reporting practices of many government departments and those of private-sector entities.

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1.2 SOURCES OF EXTERNAL FINANCIAL REPORTING REGULATION

A number of sources of regulation cover financial reporting in New Zealand. These include legislation, accounting standards, the New Zealand Securities Commission and the New Zealand Exchange.

LEGISLATION

Financial reporting in New Zealand is underpinned by a number of sources of legislation, including the *Public Finance Act 1989*, the *Local Government Act 2002,* the *Crown Entities Act 2004*, the *Financial Reporting Act 1993* (*FRA*), the *Companies Act 1993* (*CA*) and the *Securities Act 1978* together with the *Securities Markets Act 1988*. Financial reporting by private-sector entities is primarily governed by the *FRA* and the *CA*. These statutes differ in two main respects. The *FRA* details the overall financial reporting framework—the what, how and when of reporting—while the *CA* provides for the administrative requirements. Limited disclosure requirements are also contained in the *CA*.

FINANCIAL REPORTING ACT 1993

The *FRA* applies to all reporting entities. Section 2 of the *FRA* defines an entity as a company or any issuer. 'Reporting entity' is defined as an issuer, a company other than an exempt company, or a person required by another Act to report under the *FRA* as if it were a legal entity. According to s. 4 of the *FRA* an issuer is any party who has made a public issue of debt or equity securities. The term 'security' is defined in the widest possible terms, so that as many offerings of securities to the public can be caught. 'Issuer', as section 4 provides, is likewise very broad, and includes:

- entities that have allocated securities to the public subsequent to an offer which required an investment statement and/or a registered prospectus and entities that have securities quoted on the New Zealand Exchange, be it the main board or the New Zealand Alternative Market (NZAX);
- insurers to whom Part 10 of the *Injury Prevention Rehabilitation and Compensation Act 2001* applies (that is, insurers who were party to a private accident compensation policy prior to 2001);
- managers of unit trusts in which securities have been allocated according to an offer of securities to the public;
- registered banks that have allocated securities to the public;
- every recipient of money from a conduit issuer (an issuer which obtains funds from the public pursuant to an offer of securities on the basis that the funds will be passed on to another entity);
- operators of retirement villages; and
- overseas companies that offer securities to the New Zealand public.

Excluded from the definition of 'issuer' are the Crown, local authorities and superannuation schemes. Exempt companies (to be discussed later) are also excluded, unless they are classified as issuers for some other reason.

Directors of every **reporting entity** have an obligation to ensure that within five months of the balance date, financial statements that comply with s. 11 of the *FRA* are completed, dated and signed on behalf of the directors by two directors, or the sole director (*FRA*, s. 10). Section 11(1) requires the financial statements to comply with generally accepted accounting practice (GAAP).

reporting entity
When users are said to exist who do not have access to information relevant to decision making and who are judged to be dependent on general purpose financial statements, the entity is deemed to be a reporting entity.

Generally accepted accounting practice

Generally accepted accounting practice (GAAP) is described in the 'New Zealand Preface' (NZ Preface), paragraph 10, as 'the term used to describe the basis on which general purpose financial statements are prepared'. This includes the specific rules, practices and procedures relating to particular circumstances, together with the broad concepts and principles of general application. The importance of GAAP in the preparation of financial statements is recognised by the legislative requirements contained in the *FRA*. In terms of s. 3 of the *FRA*, financial statements and group financial statements comply with GAAP only if they comply with applicable financial reporting standards.

Accounting standards are the primary indicators of GAAP. For an entity to comply with GAAP, it must adhere to all applicable financial reporting standards. If a particular situation is not covered by an accounting standard (or where there is no applicable rule or law), the accounting policies of the entity should be appropriate to the circumstances, and have authoritative support within the accounting profession in New Zealand.

In New Zealand, it is the Accounting Standards Review Board (ASRB), established under the authority of the *FRA*, that has the authority to give directions as to which accounting policies have authoritative support within the accounting profession. The standards themselves are prepared mainly by the Financial Reporting Standards Board (FRSB) of the New Zealand Institute of Chartered Accountants (NZICA) and submitted to the ARSB for review and approval. (This is one area where New Zealand differs from Australia, which has one Board responsible for creating and approving its standards.) Where a transaction, other event or condition is not dealt with by an accounting standard or an interpretation of a standard, management must use their

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judgment in developing an appropriate accounting policy. Central to the development of any such accounting policy is that it must result in information that is relevant to the economic decision-making requirements of users, and be reliable (NZ Preface, para. 36). This requirement is reinforced by NZ IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', paragraph 10, which states that:

In the absence of NZ IFRS that specifically applies to a transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is:

(a) relevant to the economic decision-making needs of users; and
(b) reliable, in that the financial statements:
  (i) represent faithfully the financial position, financial performance and cash flows of the entity;
  (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
  (iii) are neutral, i.e. free from bias;
  (iv) are prudent; and
  (v) are complete in all material respects.

The process to be followed in the development of an appropriate policy is detailed in the NZ Preface, paragraph 30, and in NZ IAS 8, paragraph 11, both of which require management to adopt a hierarchical approach. In using their judgment, management should refer to, and consider the applicability of, in descending order, the following sources:

(a) the requirements and guidance in NZ IFRS dealing with similar and related issues; and
(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the NZ Framework.

In making a decision, consideration should also be given to the most recent pronouncements of other standard-setting bodies that use a similar **conceptual framework** to develop accounting standards, other accounting literature and accepted industry practices. However, care should be taken to ensure that these sources do not conflict with the requirements of NZ IAS 8, paragraph 11, just referred to.

conceptual framework Seeks to identify the objective of general purpose financial reporting and the qualitative characteristics that financial information should possess.

The NZ Preface (para. 39) suggests that technical practice aids issued by the FRSB would be an example of a pronouncement of a standard-setting body that could be used as a source of guidance in developing and applying accounting policies. Examples of well-recognised standard-setting bodies with the authority to promulgate reporting standards are those established in the United Kingdom, Canada, Australia and the United States of America.

Professional judgment should be used to resolve conflicts between sources of authoritative support when determining what constitutes GAAP. Professional judgment must also be exercised where authoritative support might be affected by the absence of or incomplete due process.

Composition of financial statements

The composition of financial statements and group financial statements is considered in ss. 8 and 9 of the *FRA*. With regard to single entities, section 8 of the *FRA* requires that financial statements for entities trading for profit comprise a statement of financial position for the entity as at the balance date, a statement of financial performance for the entity in relation to the accounting period ending at the balance date, an income and expenditure statement in relation to the reporting period for entities not trading for profit, a revenue and appropriation account for building societies, a cash-flow statement if required by a standard which applies to the reporting entity, and appropriate accompanying explanatory notes. If the company is an overseas company, the financial statements are prepared as if the company were registered in New Zealand. Group financial statements (s. 9) comprise a consolidated statement of financial position as of the balance date, and a consolidated statement of financial performance as at the balance date, if any member of the group trades for profit. If no member of the group trades for profit, then a consolidated income and expenditure statement must be completed. If any applicable reporting standard requires a statement of cash flows, one must be prepared. Should the group comprise an overseas company and its subsidiaries, then the financial statements are prepared as if the company and subsidiaries were registered in New Zealand.

Financial reporting standards, generally accepted accounting practice and the true and fair view

Sections 11 (single entities) and 14 (groups) of the *FRA* require reporting entities as defined in the Act to prepare financial statements that comply with generally accepted accounting practice. Generally accepted accounting practice describes the basis on which general purpose financial statements are normally prepared. According to the NZ Preface, commentary paragraph 10, the term encompasses:

(a) specific rules, practices and procedures relating to particular circumstances; and
(b) broad concepts and principles of general application.

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Section 3 of the *FRA* provides that financial statements will comply with generally accepted accounting practice only if those statements comply with:

- applicable financial reporting standards; and
- where there are no applicable financial reporting standards or rule of law, with accounting policies that are appropriate to the circumstances of the reporting entity and have authoritative support within the accounting profession in New Zealand.

Accounting standards are the primary indicators of generally accepted accounting practice. Where no applicable accounting standard or applicable rule of law exists, entities must adopt accounting policies that are appropriate and have authoritative support within the accounting profession.

true and fair view
Disclosures are regarded as giving a true and fair view if they provide all relevant information and comply with all applicable accounting standards.

Compliance with generally accepted accounting practice usually means that financial statements give a **true and fair view** of an entity's financial position, performance and cash flows. In circumstances where compliance with generally accepted accounting practice does not result in a true and fair view, s. 11 of the *FRA* and NZ IAS 1 'Presentation of Financial Statements' require that the **directors** of the entity provide additional information and explanations in order to ensure that a 'true and fair' view of the general purpose financial statements is provided.

director
Any person, regardless of the name given the position, who is appointed to the position of director, alternate director or member of a governing body.

There is no legal definition of 'true and fair'. Even though the *FRA* requires that directors of an entity ensure that financial statements provide a 'true and fair' view, neither the *FRA* nor the *CA* defines the concept. The New Zealand accounting profession has not provided definitive guidelines on truth and fairness either.

There are two possible interpretations of the phrase:

1. a technical interpretation suggesting that the definition is met by companies complying with accounting standards when preparing general purpose financial statements; or
2. an absolute or literal interpretation, which argues that the phrase implies more than simply complying with accounting standards.

The fair presentation override

Section 11 of the *FRA* and NZ IAS 1 'Presentation of Financial Statements', paragraph 13, contains a true and fair override. NZ IAS 1 requires financial statements to present fairly the financial position, financial performance and cash flows of an entity. In this context, fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the NZ Framework. In emphasising the importance of compliance with IFRSs, NZ IAS 1, paragraph 14, requires entities to make an 'explicit and unreserved statement' that they comply with IFRS requirements. Financial statements cannot be described as being in compliance with IFRSs unless all IFRS requirements are complied with, which can be incompatible with presenting a true and fair view.

What this means is that general purpose financial statements prepared by New Zealand entities will only achieve fair presentation in circumstances where they have been prepared in compliance with the requirements of the New Zealand equivalents to IFRSs, as well as providing any additional disclosures necessary to ensure fair presentation. This is achieved according to NZ IAS 1, paragraph 15, by:

- the selection and application of accounting policies in accordance with NZ IAS 8;
- presenting information, including accounting policies, in such a way that relevant, reliable, comparable and understandable information is provided; and
- providing sufficient additional disclosures when compliance with specific requirements in New Zealand equivalents to IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

Within the context of the NZ Preface, the terms 'fair presentation' and 'fairly reflect' have the same meaning as 'true and fair view'. This means that if financial statements that have been prepared in accordance with accounting standards do not provide a true and fair view, additional information and explanations must be provided to ensure a true and fair view. This would suggest that in New Zealand the more absolute or literal interpretation of the true and fair view applies.

COMPANIES ACT 1993

The *CA* is applicable to all companies. As such it has a narrower focus than the *FRA*, which applies to all companies and all issuers. As has been noted, the *CA* details administrative and limited disclosure requirements.

Administrative provisions

The administrative requirements applicable to financial statement disclosure are contained in ss. 208 and 209. Under s. 208, the board of every company is required, within five months of the balance date, to prepare an annual report on the affairs of

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the company, although exempt companies have nine months in which to do so. The annual report or a notice specifying that a copy of the report can be requested or providing the necessary information to obtain an electronic copy of the report should be sent to every shareholder no fewer than 20 working days before the date fixed for holding the annual meeting (s. 209(1) and (3)), unless the shareholder has waived their right (in writing) to receive a copy of the report. A company also has the option to prepare a concise annual report for its shareholders, which contains either financial statements and the auditor's report if any, or summary financial reports for the period (s. 209(5)). The report must, however, be available for inspection by shareholders.

Statutory disclosure provisions

Section 211 of the *CA* details the content requirements of annual reports. The overriding consideration is provided by s. 211(1), which requires annual reports to be in writing and to be dated. In addition, the report should include completed and signed (on behalf of the board by two directors or the sole director if only one) financial statements that comply with the provisions of the *FRA*, and an auditor's report. Shareholders may vote unanimously to exclude some of the requirements of s. 211(1) and (2) if they wish to have a shorter report provided to them.

Directors' responsibilities

In terms of section 194 of the *CA*, the directors of a company are responsible for the maintenance of accounting records. These accounting records should be maintained in such a way that all transactions entered into by the company are accurately recorded, and can be adequately explained. The *CA* requires that, at any time during the reporting period, the financial position of the company be determinable with reasonable accuracy from the accounting records that have been kept. Section 194(1) further requires that the accounting records be maintained in such a manner that, when financial statements are prepared, they comply with either section 10 or section 13 of the *FRA* as appropriate and can be readily and properly audited.

Although not specifically required, a number of New Zealand companies include a section in their directors' report detailing the directors' responsibilities. The statement of directors' responsibilities shown in Exhibit 1.1 has been extracted from the 2007 financial statements of Sky Network Television Limited.

Exhibit 1.1

Directors' responsibility statement—Sky Network Television Limited

DIRECTOR'S RESPONSIBILITY STATEMENT

The directors of Sky Network Television Limited (the Company) are responsible for ensuring that the financial statements of the Company give a true and fair view of the income statement of the Company and the Group as at 30 June 2007 and its balance sheet and cash flows for the year ended on that date.

The directors consider that the financial statements of the Company and the Group have been prepared using appropriate accounting policies, consistently applied and supported by reasonable judgements and estimates and that all relevant financial reporting and accounting standards have been followed.

The directors believe that proper accounting records have been kept which enable, with reasonable accuracy, the determination of the financial position of the Company and the Group and facilitate compliance of the financial statements with the Financial Reporting Act 1993.

The directors consider they have taken adequate steps to safeguard the assets of the Company and the Group and to prevent and detect fraud and other irregularities.

The directors have pleasure in presenting the financial statements of the Company and Group for the year ended 30 June 2007.

The board of directors of Sky Network Television Limited authorise these financial statements for issue on 16 August 2007.

For and on behalf of the board of directors

Peter Macourt
Chairman

Robert Bryden
Director

Date: 16 August 2007

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Directors' report

Unlike Australia, there is no New Zealand *CA* requirement for entities to prepare a directors' report, and no mention of a directors' report in the *FRA*. While the *CA* does require certain disclosures to be made in financial statements, how these items should be disclosed is not specified. For example, s. 211(1)(a) requires that every annual report of a company be in writing, be dated and describe, so far as the board believes is material for the shareholders to have an appreciation of the state of the company's affairs and not to harm the business of the company or of any of its subsidiaries or change during the accounting period

> *(i) the nature of the business of the company or any of its subsidiaries; or*
> *(ii) the classes of business in which the company has an interest, whether as a shareholder of another company or otherwise.*

In addition to the requirement that the annual report be in writing and be dated, s. 211(1) also requires that a number of additional items be disclosed. These include:

- particulars of entries in the interests register made during the accounting period; and
- the names of persons holding office as directors of the company as at the end of the accounting period as well as the names of any persons who ceased to hold office as directors of the company during the accounting period.

Despite the lack of requirement to do so, New Zealand companies whose shares are listed on the New Zealand Stock Exchange usually do provide some form of report, described either as a directors' or chief executive's report. In addition to the statutory information specifically required by the *CA*, the report includes information about the principal activities of the company, significant changes in the state of affairs of the company and likely future developments.

The directors' or chief executive's report often includes a great deal of further information provided by companies on a voluntary basis. For example, in recent years a number of New Zealand companies have provided information about community-based projects in which they are participating, employee training schemes and safety initiatives and company-promoted environmental initiatives—sometimes in the form of a separate stand-alone report.

ACCOUNTING STANDARDS

The section that follows considers the background to the accounting standard-setting process and the roles played by the bodies involved in that process.

BACKGROUND TO THE NEW ZEALAND ACCOUNTING STANDARD-SETTING PROCESS

Until 1993, the regulation of the accounting profession in New Zealand was in the hands of the private sector. The responsibility for the development and issue of accounting standards fell to the New Zealand Society of Accountants (NZSA). A committee appointed by the Council of the NZSA, the Accounting Research and Standards Board, developed standards. The enforcement of standards by the NZSA relied on persuasion and the requirement that members auditing financial reports disclose where departures from standards had occurred. Where members failed to comply with the accounting standards when preparing or reporting on financial statements, sanctions against these members were possible.

The 1987 share market collapse led to a Ministerial Committee of Inquiry under a former Reserve Bank governor, Sir Spencer Russell. The inquiry was mandated to review share market law and recommend changes necessary to ensure the existence of a fair and efficient market. The inquiry criticised the quality of financial reporting and the level of non-compliance with accounting standards in New Zealand. In the report prepared by the committee, a number of recommendations were made. These included that:

- legal backing be given to accounting standards;
- an Accounting Standards Review Board to approve accounting standards be established; and
- sanctions be introduced for non-compliance with standards.

ACCOUNTING STANDARDS REVIEW BOARD

Accounting Standards Review Board (ASRB)
An independent body set up under the *Financial Reporting Act 1993* to review and, where appropriate, approve financial reporting standards.

The *FRA* is the primary statute governing the establishment of accounting standards in New Zealand. Section 22 of the *FRA* establishes the **Accounting Standards Review Board (ASRB)**. The purpose of the ASRB is to review and, where appropriate, approve financial reporting standards. This has the effect of providing legal backing for accounting standards.

The ASRB is constituted as a body corporate under the *FRA* and is a Crown entity under the *Crown Entities Act 2004*. The Governor-General, on the recommendation of the Minister of Commerce, appoints its members by virtue of their knowledge or experience in law, business, finance, economics or accounting. The functions of the ASRB are established by s. 24, which provides that the Board is required:

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(a) To review and, if it thinks fit, approve financial reporting standards submitted to it for approval for the purposes of—

(i) this Act; or

(ia) the Crown Entities Act 2004; or

(ii) the Public Finance Act 1989; or

(iia) the Local Government Act 1974; or

(iii) any Act that requires a person to comply with this Act as if that person were a reporting entity;

(b) To review, and, if it thinks fit, approve amendments to any approved financial reporting standards;

(c) To make recommendations in relation to the submission to it for approval of financial reporting standards or amendments to approved financial reporting standards;

(d) To give direction as to the accounting policies that have authoritative support within the accounting profession in New Zealand;

(e) To encourage the development of financial reporting standards, including financial reporting standards for different classes of reporting entity;

(ea) To grant exemptions under section 29A;

(f) To liaise with the Accounting Standards Board established by the Securities Commission Act 1989 of Australia with a view to harmonising New Zealand and Australian financial reporting standards.

The members of the ASRB are to number no fewer than four and no more than seven. As indicated earlier, the Governor-General on the recommendation of the Minister appoints these individuals. Currently, the majority of members of the ASRB are chartered accountants.

The role of the ASRB is set out in ASRB Release 8, issued in 2004. This release outlines the functions of the ASRB, the nature of approved accounting standards and the criteria the ASRB will employ in evaluating proposed accounting standards. The specific functions of the ASRB detailed in ASRB Release 8 are the same as those contained in s. 24 of the *FRA*.

Note that by virtue of ss. 25 and 26 of the *FRA*, while the New Zealand Institute of Chartered Accountants does not have a monopoly on submitting standards to the ASRB, the Financial Reporting Standards Board does control the process. Although a proposed accounting standard can be submitted to the ASRB by any organisation, it will not be approved unless the ASRB is satisfied that the body submitting the standard has taken reasonable steps to consult with organisations and individuals likely to be affected by the standard. This means that an equivalent process (to that described later in this chapter) must be followed by the party submitting the standard, and the Financial Reporting Standards Board must be included in the consultation process.

APPLICATION OF ACCOUNTING STANDARDS

According to s. 27 of the *FRA*, accounting standards approved by the ASRB normally apply to financial statements prepared by all reporting entities or groups, specified reporting entities or groups, or specifically to the Crown, all or some departments or offices of Parliament or Crown entities and all or some local authorities. The section also contains provision for the ASRB to specify application of standards to accounting periods or interim accounting periods. In other words, the ASRB is entitled to specify that standards can have differential application. The term 'reporting entity' is used to cover all issuers, companies other than exempt companies and any person who is required by any other Act to comply with the *FRA* as if it were a reporting entity, while 'companies' means companies incorporated or registered under the *CA*.

Companies with fewer than twenty-five shareholders are excluded if the only securities they have issued to the public are equity securities, and unless they are classified as an issuer for some other reason.

Other smaller companies are treated as an exempt category. Section 6A of the *FRA* classifies an exempt company as a company or issuer if, in the accounting period for which financial statements are prepared, the company can satisfy two of the following three criteria:

- reported total assets, including intangible assets, did not exceed $1 000 000 in the relevant accounting period;
- turnover did not exceed $2 000 000 in the relevant accounting period; and
- in the relevant accounting period the company had 5 or fewer equivalent full time employees.

These figures are able to be amended by the Governor-General from time to time.

In addition the company must be able to satisfy the Registrar of Companies that:

- the company was not a subsidiary; and
- the company did not have subsidiaries.

In terms of s. 12 of the *FRA*, these companies are required to report only in terms of the prescribed form, the *Financial Reporting Order*.

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REVIEW OF THE *FINANCIAL REPORTING ACT 1993*

A review of the *Financial Reporting Act 1993* (*FRA*) as part of a broader raft of company law reforms was commenced early in 2004. A number of factors contributed to the need to review the *FRA*, including the global trend towards international financial reporting standards (IFRSs) and the perception that certain aspects of the financial reporting regimen were due for an overhaul. Among the issues the Ministry of Economic Development (MED) wished to be considered in the review were the scope of the Act's application (i.e. the question of who should be required to report); the institutional arrangements for financial reporting; enforcement mechanisms; and auditors and auditing standards. In addition the MED also wished the trans-Tasman dimension to be taken into account, in particular the formation of a Trans-Tasman Accounting Standards Advisory Group.

The review was undertaken in two parts, the first commenced in March 2004 with the issue by the MED of a public discussion paper entitled *Review of the Financial Reporting Act 1993 Part I: The Financial Reporting Structure*. The second part of the review commenced in November 2004 with the issue of a further MED discussion paper, *Review of the Financial Reporting Act 1993 Part II*. This discussion paper covered a variety of financial reporting issues not considered in the first review, including the institutional arrangements for financial reporting; enforcement mechanisms; and auditors and auditing standards. It included a revised proposal on who should provide financial reports that took into account concerns raised in response to the first discussion document.

Submissions on both the discussion papers were received from a wide range of entities, including public and private companies, government agencies, legal and accountancy firms, representative bodies, academics, private individuals and the not-for-profit sector. A summary of the submissions can be found below.

The first part of the review revealed a number of broad areas of interest:

- whether some form of differential reporting requirements are appropriate;
- whether there should be at least three tiers of reporting entities;
- whether the numerical thresholds for employees should be increased to 50 from 20;
- whether reporting requirement for tier 3 entities should be removed, and a 'best practice' reporting guide provided for these companies;
- whether businesses that are closely-held, operated by their owners, and with potentially very few (or no) external stakeholders should be required to report publicly;
- the potential cost implications of requiring not-for-profit entities to produce complex financial reports; and
- concern at the lack of detail as to the substantive reporting requirements of tier 2 entities.

Respondents to the second part of the review generally supported the Ministry's proposals to reconstitute the ASRB with a broader range of functions, powers and membership. However, broad consensus was not reached on the matter of reporting entities, that is, the question of who should be required to report. There was however broad support for the proposals relating to the practical aspects of financial reporting (including electronic publication of financial reports, the use of XBRL and an exemption for non-active entities). Finally, respondents did not believe that New Zealand had any concerns about the audit profession requiring immediate or urgent reform although it is a matter that the Ministry keeps under review, with work currently being done in the area.

The review resulted in changes to the *Financial Reporting Act*, which were passed in November 2006 but took effect at different times. The discussion of the requirements of the *FRA* in this chapter reflects the current state of the law since the amendments took effect.

FRAMEWORK FOR DIFFERENTIAL REPORTING

Financial Reporting Order
Exempt companies under s. 2 of the *Financial Reporting Act 1993* are only required to report under the Financial Reporting Order.

As has been noted, exempt companies under s. 2 of the *FRA* are required to report only in terms of the **Financial Reporting Order**. All other reporting entities are required to report in terms of the *FRA*.

This chapter has noted that the ASRB provides direction for entities that fall within its jurisdiction on accounting policies that have authoritative support within the accounting profession in New Zealand. Enjoying such authoritative support is the 'Framework for Differential Reporting for Entities Applying the New Zealand Equivalents to the International Financial Reporting Standards Reporting Regime' (Differential Framework). The Differential Framework forms part of generally accepted accounting practice for the purposes of the *FRA* and sets out the concessions available under the reporting regime to qualifying entities required to prepare general purpose financial statements that comply with GAAP.

The Differential Framework applies to general purpose financial statements only and not to special purpose financial reports prepared for organisations such as banks and other financial institutions or government and credit rating agencies. Under the Differential Framework, qualifying entities preparing general purpose financial statements are granted full or partial exemption from complying with certain financial reporting standards. For example, a qualifying entity is granted full exemption from complying with NZ IAS 7 'Cash Flow Statements', and partial exemption from a number of other accounting standards,

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including NZ IAS 2 'Inventories' and NZ IAS 12 'Income Taxes'. The complete list of differential reporting concessions available to qualifying entities is detailed in Appendix 1 to the Differential Framework.

The use of a differential reporting framework can be justified on the grounds that by limiting the application of a framework to small or closely held companies, accounting standards overload and compliance costs are reduced.

The Differential Framework recognises the difficulties associated with measuring the costs and benefits of financial reporting requirements. To counter these difficulties, surrogates are used, based on the following broad assumptions:

- more benefits are derived from financial reports of entities with public accountability because these reports are likely to have more users;
- generally there will be no external accountability requirements when all the owners of an entity are members of its governing body; and
- the larger the entity, the more extensive the group of users benefiting from information contained in the financial reports and the greater the benefit likely to be derived.

Based on the above assumptions, the three surrogates for the costs versus benefits criterion for a reporting entity identified in paragraph 3.1 of the Differential Framework are:

(a) public accountability;
(b) separation of owners and governing body of an entity; and
(c) size.

An entity therefore qualifies for differential reporting exemptions, according to paragraph 3.11 of the Differential Framework if the entity does not have public accountability, and:

(i) at balance date, all of its owners are members of the entity's governing body; or
(ii) the entity is not large in terms of paragraph 3.9.

An entity is considered large (para. 3.9) if it exceeds any two of the following:

(a) total income of $20.0 million;
(b) total assets of $10.0 million;
(c) 50 employees.

Financial statements of exempt companies (s. 6A of the *FRA*) may also be prepared in accordance with the Differential Framework, provided the requirements of the *Financial Reporting Order* are met.

FINANCIAL REPORTING STANDARDS BOARD

The **Financial Reporting Standards Board (FRSB)** is a board of the New Zealand Institute of Chartered Accountants (NZICA) whose members are appointed by the Council of the Institute. Appointment criteria are based on both sector representation and knowledge or experience of accounting. The FRSB has as its objective the development and maintenance of definitive accounting standards and providing guidance in the form of research bulletins or technical practice aids on all aspects of financial reporting. The NZ Preface, paragraph 2, explains that the FRSB aims continually to improve the quality of general purpose financial statements and non-financial statements so that users are provided with sound information to enable them to make economic decisions. Consistent with the NZ Framework, the NZ Preface regards such information as information that enables users to:

Financial Reporting Standards Board (FRSB) A board of the New Zealand Institute of Chartered Accountants responsible for developing and revising financial reporting standards and developing sources of authoritative support.

(a) assess the performance, financial position and cash flows of the entity;
(b) assess the entity's compliance with legislation, regulations, common law and contractual arrangements, as they relate to the assessments of the entity's performance, financial position and cash flows; and
(c) make decisions about providing resources to, or doing business with, the entity.

The NZ Preface argues that information of this nature assists in maintaining the efficiency of New Zealand capital markets and improving the accountability of profit-oriented and public benefit entities.

The FRSB is to meet its objectives, according to the NZ Preface, paragraph 3, by:

- working with the IASB to bring about a set of high quality international financial reporting standards;
- contributing to the work of the International Federation of Accountants (IFAC) in developing International Public Sector Accounting Standards (IPSASs);
- developing New Zealand equivalents to IFRSs for application by New Zealand entities (for example, by including references to the regulatory environment within New Zealand);
- where necessary, developing FRSs and other forms of guidance;

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- where appropriate forwarding New Zealand equivalents to IFRSs, and FRSs, to the Accounting Standards Review Board (ASRB) for approval;
- liaising with the Australian Accounting Standards Board (AASB) with the objective of harmonising financial reporting standards in Australia and New Zealand; and
- engaging in research in both the private and the public sectors.

DEVELOPMENT OF AN ACCOUNTING STANDARD

Until 1997, the development of an accounting standard commenced with a subject, duly selected for detailed study by the FRSB or one of its committees, being adopted. These projects originated from a number of sources, including:

- outcomes of IASC (as it was then known) work programs;
- harmonisation with Australia;
- issues raised by NZICA members, auditors, preparers or users;
- responses to changes or new developments in the business environment; or
- review of changes to existing financial reporting standards in response to the continued development of the Statement of Concepts.

In 1997, the FRSB decided that future accounting standards would be developed based on standards issued by the IASC or the AASB. These would be modified to ensure that the terminology was sector-neutral and that the terminology and format were consistent with other New Zealand pronouncements. A discussion paper would accompany the exposure draft outlining the implications for New Zealand entities of the IASC or AASB position adopted.

The decision by the ASRB in 2002 that New Zealand entities would be required to apply IFRSs issued by the IASB did not result in any changes to the accounting standard-setting process. The FRSB remained responsible for the due process in respect of all New Zealand equivalents to IFRSs submitted to the Board for approval.

In order to establish constituents' views on existing IFRSs and the need for any additional requirements, the FRSB reviews existing IFRSs and prepares an exposure draft (ED) of each proposed New Zealand IFRS equivalent for comment. The exposure drafts contain the text of the IFRS and highlight additional requirements. Included with each ED is a discussion paper that provides a summary comparison of the IFRS and corresponding requirements under existing FRSs. The ED is published on the New Zealand Institute of Chartered Accountants' (NZICA) website and remains open for two months. Forums or arrangements to enable further discussion and exchange of views can be arranged.

During the period of exposure, the FRSB requests comments on:

- the proposed additional requirements, if any, and also on the need for any further requirements (with particular reference to public benefit entities); and
- any regulatory issues or other factors specific to the New Zealand economic and legal environment that could affect implementation of the IFRS; and
- issues relating to the *Privacy Act 1993*.

All the submissions received on EDs are considered by the FRSB. After consideration, the proposed New Zealand equivalents to IFRSs are submitted to the Board for approval. The draft standard is accompanied by a report on the consultation process undertaken, a summary of all significant issues raised in the submissions received, and an indication of how they were resolved. ASRB Release 8, paragraph 34, requires the FRSB's report to the ASRB to include:

> *where appropriate, an impact analysis and assessment of the anticipated effects of the standard on the financial statements of specified entities in New Zealand, including costs and benefits.*

Once approved by the ASRB, the New Zealand equivalent to an IFRS is included in the Members' Handbook.

Future standard-setting structure

The adoption of IFRSs in New Zealand has meant a reassessment of the roles of the FRSB and the ASRB. The FRSB will no longer take responsibility for identifying and developing future accounting standards, which means its domestic standard-setting role is virtually eliminated. The FRSB, together with the accounting standard setters of Australia, Canada, France, Germany, Japan and the United States, now has a standard-setting role in partnership with the IASB. The FRSB appears to have been relegated to the coordination of submissions on EDs, the submission of New Zealand positions on IFRSs and the provision of input on IASB projects. The result of this is a potential loss of intellectual capital when it comes to standard setting.

The importance of complying with IFRSs has led Bradbury and van Zijl (2005, p. 14) to make the following observations:

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If entities do not comply with all international standards, they cannot claim compliance with IFRSs. This means that the ASRB is unlikely to refuse to approve an IFRS. What, therefore, is the remaining substantive role (if any) of the ASRB? What will happen when full convergence with IFRSs is achieved in 2007? Members of ICANZ might ask why they need to support the FRSB from their membership fees. Why not simply adopt IFRSs? If there was no FRSB, and if the national standard setters in other countries were weakened or abolished, what would be the impact on the functioning of the IASB?

INTERNATIONAL FINANCIAL REPORTING INTERPRETATIONS COMMITTEE

Accounting issues requiring urgent attention usually arise from uncertainties on how a particular financial reporting standard should be applied or in resolving issues not covered by an existing financial reporting standard, such as accounting for the costs incurred by companies to ensure that they were year-2000 compliant.

A number of standard-setting bodies in other jurisdictions have groups that consider pressing accounting issues that arise in implementing accounting standards. These bodies and the names of the relevant groups are identified in Table 1.1. The IASB's body responsible for this function is the International Financial Reporting Interpretations Committee (IFRIC).

IFRIC replaced the IASB's interpretative body, the Standing Interpretations Committee (SIC), in 2002. The function of IFRIC is to review, within the context of current international financial reporting standards (IFRSs) and the IASB Framework, accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance. The aim is to work closely with similar national committees to achieve consensus on appropriate accounting treatment.

IFRIC does not concern itself with issues of concern only to small minorities of entities. Rather it aims to develop interpretations that cover both:

- newly identified financial reporting issues not specifically dealt with by IFRSs; or
- issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance, with a view to reaching consensus on the appropriate treatment.

In addition, IFRIC is responsible for:

- interpreting the application of IFRSs and providing guidance on financial reporting issues not specifically addressed in IFRSs, in the context of the IASB Framework;
- publishing draft interpretations for public comment and considering comments made within a reasonable period before finalising an interpretation; and
- reporting to the IASB and obtaining its approval for final interpretations.

Table 1.1

Urgent issue groups internationally

PARENT BODY	NAME OF GROUP	DATE ESTABLISHED
Financial Accounting Standards Board—USA	Emerging Issues Task Force	1984
Canadian Institute of Chartered Accountants	Emerging Issues Committee	1988
Accounting Standards Board—UK	Urgent Issues Task Force	1991
Australian Accounting Research Foundation	Urgent Issues Group	1995
International Accounting Standards Board	International Financial Reporting Interpretations Committee (IFRIC)	2002

NEW ZEALAND SECURITIES COMMISSION

The New Zealand Securities Commission (SC) is established under the *Securities Act 1978*. It is a statutory corporation, which, in all matters other than funding and the appointment of its members, is expected to act independently of the New Zealand Government and others. The SC has an enforcement function in relation to registered prospectuses, investor statements and advertisements for securities offered to the public in New Zealand. By prescribing the information that should be contained in prospectuses and improving information disclosure, the SC is seeking 'to strengthen investor confidence and foster capital investment in New Zealand'. This is achieved by promoting the efficiency, integrity and cost-effective regulation of New Zealand markets. In this way the SC hopes to increasingly attract investment from New Zealand and overseas.

In relation to the issuers of securities to the public, the SC's website <www.seccom.govt.nz> states that the Commission contributes to:

- high standards of disclosure;
- good corporate governance;
- reliable and ethical procedures for effecting transactions;
- high quality accounting and financial reporting practices;
- flexibility in development of best regulatory practice;
- sound principles for market regulation;

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- cost-effective rules of law;
- compliance with the law;
- good working relationships with overseas regulators; and
- public understanding of the law and practice of securities.

A noteworthy development brought about by the SC is the publication of the text *Corporate Governance in New Zealand: Principles and Guidelines*. As indicated in the document, the principles are:

> *intended to contribute to high standards of corporate governance in New Zealand entities. This will be achieved when directors and boards implement the Principles through their structures, processes, and actions, and demonstrate this in their public reporting and disclosure. <www.sec-com.govt.nz/publications/documents/ governance-principles/01.shtml>*

The essential principles for corporate governance identified by the SC are the following:

- Directors should observe and foster high ethical standards.
- There should be a balance of independence, skills, knowledge, experience and perspectives among directors so that the board works effectively.
- The board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility.
- The board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs.
- The remuneration of directors and executives should be transparent, fair and reasonable.
- The board should regularly verify that the entity has in operation appropriate processes that identify and manage potential and relevant risks.
- The board should ensure the quality and independence of the external audit process.
- The board should foster constructive relationships with shareholders that encourage them to engage with the entity.
- The board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose.

The SC requires these principles to be generally applied in the governance of those entities that have economic impact in New Zealand or are accountable, in various ways, to the public. This includes listed issuers, other issuers, state-owned enterprises, community trusts and public sector entities. The SC cautions that not all principles can be applied wholly to all entities. For example, public-sector organisations do not have shareholders in the traditional sense, and board appointments are subject to a specific board appointment process. Public-sector organisations nevertheless have an owner and are accountable to that owner, other stakeholders and the public. Entities should only depart from the principles where they are subject to competing statutory or public policy requirements and explanations should be provided for any departures from the principles.

New Zealand Exchange (NZX)
Sets uniform trading rules, ethical standards and listing requirements.

NEW ZEALAND EXCHANGE

For those reporting entities that have securities listed on the **New Zealand Exchange (NZX)**, there are further reporting requirements over and above those provided by the accounting profession or legislation. These are contained both in Part 2 of the *Securities Markets Act 1988* and in the New Zealand Exchange Listing Rules. Failure to comply with the requirements to continuously disclose information that is or could be material to the market can lead to the trading in the entity's shares being suspended. The SC also has enforcement powers under the *Securities Markets Act*, both civil and criminal.

The NZX and SMA disclosure requirements assist in ensuring that information about listed entities is disseminated in an efficient and timely manner. The listing rules include disclosure requirements for half-yearly and preliminary announcements. They also reduce the likelihood of individuals prospering from access to privileged information. The NZX also operates a continuous disclosure regime, which requires listed companies to inform the market of issues that do or may affect the price of its securities. This rule is based on the general principle that: 'Without limiting any other NZX Listing Rule, every NZX Issuer shall once it becomes aware of any Material Information concerning it, immediately release that Material Information to NZX' <www.nzx.com/regulation/listed_issuer/listingRulesTOC/view>.

In addition, the NZX is able to require companies to comply with particular accounting standards. For example, prior to the adoption of IFRSs, the NZX required New Zealand listed companies to comply with IAS 33 'Earnings Per Share' when reporting on earnings per share rather than making use of any other source of authoritative support.

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1.3 NEW ZEALAND'S ADOPTION OF ACCOUNTING STANDARDS ISSUED BY THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

In October 2002, the ASRB announced that it had decided to recommend to the Government and other affected bodies that from 2007 listed issuers are required to comply with international financial reporting standards (IFRSs) issued by the IASB. These issuers would be permitted to adopt IFRSs from 2005.

The ASRB decision was a direct consequence of the Australian Financial Reporting Council's (FRC) directive to the Australian Accounting Standards Board to adopt international financial reporting standards (IFRSs). These standards were previously referred to as international accounting standards (IASs). The catalyst for the FRC's directive was a decision by the European Union that all listed companies within the European Union should adopt IASB standards by 1 January 2005 for the purposes of preparing consolidated financial statements. This was to support the 'single market objective' that has been embraced within the European Union. The expressed intention was that the European Union would be adopting international financial reporting standards directly, without modification.

As can be seen from Financial Accounting in the News 1.1, which features an article by Roeland van den Bergh entitled 'Accounting move stuns NZ' that appeared in the 9 October 2002 issue of *The Dominion Post*, the decision by the FRC caught the ASRB and the New Zealand accounting profession by surprise.

1.1 FINANCIAL ACCOUNTING IN THE NEWS

ACCOUNTING MOVE STUNS NZ

New Zealand has been left out in the cold by Australian accounting authorities, which have decided unilaterally to adopt international accounting standards.

The Financial Reporting Council in Australia has moved to adopt international accounting standards by 1 January 2005, providing the Australian Accounting Standards Board is satisfied that the change would not damage the economy.

New Zealand Accounting Standards Review Board chairman John Hagen said the Australian decision came out of left field and would have 'serious implications' for New Zealand organisations. 'It was extraordinary that that decision was made by the Financial Reporting Council in Australia, I'm told, without consultation with the Australian Accounting Standards Board which reports to it, and certainly came right out of left field.

'We were never apprised that this development might be occurring. It was quite an extraordinary development. Because most of our major listed organisations are also listed in Australia, this clearly has implications for us.'

The Accounting Standards Review Board will hold a special meeting on 21 October to discuss the issue.

The change would have potentially significant impacts on business reporting for issues such as deferred tax, fair value accounting for derivatives and even agriculture.

The key issue for New Zealand would be to decide whether to follow the Australians and make it easier for companies listed on both stock exchanges. 'But if we do that as a single step, that gives us a problem with our commitment to have one set of standards for both private sector and the public sector,' Mr Hagen said.

In the end, New Zealand might have no choice other than to follow suit, he said.

New Zealand and Australia had been working towards harmonisation of accounting standards, but not necessarily to the extent of adopting international accounting standards.

'In the past, we have said it would be good if we can get closer, but our concentration was harmonisation with Australia. Now Australia have said we are going to adopt international accounting standards, it sort of leaves us out in the cold,' he said.

The international standards are set by the London-based International Accounting Standards Board.

Australian companies would have to report in accordance with international accounting standards, which would replace existing Australian Accounting Standards.

Until now, Australia and New Zealand have tried to ensure that all financial reporting standards applied to both the private and the public sectors.

The two countries had led the world in public sector accounting reforms in the past 10 or more years, Mr Hagen said.

However, the International Accounting Standards Board does not pay any attention to public sector issues, making it difficult to adopt those standards without changes recognising the public sector issues. There were also questions about whether New Zealand could meet the 2005 deadline.

Mr Hagen said he was talking to the Australian Accounting Standards Board to discuss the logistics of the change.

There was already considerable alignment between the New Zealand and international standards and a change would reduce costs to companies in the long term. But there might be some short term transition costs.

'If we could agree to one set of standards, that would be great. There would have to be some flexibility because of different laws in different jurisdictions.'

Source:
Roeland van den Bergh, 'Accounting move stuns NZ', *The Dominion Post*, 9 October 2002.

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However, the ASRB justified its stance on the grounds of New Zealand's close economic ties with Australia and the tendency for international investors to group New Zealand and Australia together. They argued that failure to follow the Australian lead in the adoption of international financial reporting standards would be costly and could place at risk the credibility of financial reporting in New Zealand.

The 'new' standards within New Zealand will be referred to as New Zealand equivalents to international accounting standards, each bearing the prefix NZ IAS or NZ IFRS, and possibly featuring some minor departures from the corresponding international accounting standards (for example, they might include more explanatory material)—but essentially they will be the same as the international accounting standards (which, as has already been indicated, are referred to as IFRSs). IFRSs are developed for the 'for-profit' sector (or for profit-seeking companies). Within New Zealand, however, NZ IAS standards have general applicability to the not-for-profit and local government sectors too. Hence, material will need to be added by the Financial Reporting Standards Board (FRSB) that describes the scope and applicability of the standards in the New Zealand context.

Existing standards issued by the IASB often include a number of options (for example, the choice to expense or capitalise a particular item of expenditure). In recent times the FRSB has been reluctant to include alternatives in accounting standards. That is, it has attempted to restrict the ability of organisations to select accounting policies based on management's preference. In the New Zealand context the number of options within the IFRS-equivalent accounting standards is expected to be restricted. Therefore, some NZ IAS standards will have fewer options than are available in the equivalent IFRS. Nevertheless, compliance with the NZ IAS standard would still mean compliance with the IASB standard. The NZ IAS standards might also require additional disclosures, particularly if previous accounting standards already have more detailed disclosure requirements. Any changes to the respective IFRSs will be readily identified within the final NZ IAS accounting standard by means of a 'grey letter' paragraph. The FRSB will issue future NZ IAS standards in New Zealand at about the same time the standards concerned are issued by the IASB.

While the FRSB will be issuing standards (with slight changes, as just noted) to match those being issued by the IASB, it is possible that from time to time the FRSB might issue standards to cover areas not addressed by the IASB. That is, the FRSB will develop additional standards to cater for issues of a domestic nature. The FRSB will also advise the IASB of issues that it believes should be covered within IASB standards.

The decision by the ASRB that New Zealand would adopt IFRSs by 2007 produced sweeping change in New Zealand accounting standards that has been unparalleled in the country's financial reporting history. The decision required reporting entities to prepare financial statements in accordance with IFRSs for accounting periods beginning on or after 1 January 2007, with the option of adoption from 1 January 2005.

As has been indicated, the FRSB decided in 1997 to pursue a policy of international convergence and international harmonisation of New Zealand financial reporting standards. In this context international convergence means working with other standard-setting bodies to develop new or revised financial reporting standards and ultimately a single set of standards for worldwide use. In the New Zealand context, international harmonisation is a process that led to New Zealand's financial reporting standards being made compatible with the standards of international standard-setting bodies to the extent that this results in high quality standards. This entails adopting accounting standards issued by the IASB with modifications for any uniquely New Zealand factors. This policy was trialled in May 1999 with the issue of the first two exposure drafts based on IASB pronouncements. ED-86 'Provisions, Contingent Liabilities and Contingent Assets' and ED-87 'Accounting for Intangible Assets' were almost verbatim copies of the corresponding IASB standards, except for minor changes in terminology and format.

The decision to adopt these standards as a foundation for the development of financial reporting standards is based on three grounds. These are:

1. acknowledgement that it is desirable to work towards harmonisation;
2. recognition of the improved quality of international accounting standards and moves towards harmonisation overseas; and
3. a search for efficiency in developing standards.

A number of factors informed the decision to adopt IASB standards. Hickey and Westwood (2000, p. 83) identified these as follows:

> *New Zealand is one of the jurisdictions experiencing the stakeholder and political heat to harmonise. For example, increased government funding through the Ministry of Commerce (now Ministry of Economic Development) for defined standard-setting activities in New Zealand is likely to be conditional on adoption of appropriate overseas standards such as those of Australia and the International Accounting Standards Committee (IASC). Also, the New Zealand Exchange has lobbied to have New Zealand directly adopt standards issued by the IASC and no longer develop 'New Zealand-made' standards.*

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At this point it is appropriate to question whether New Zealand should simply adopt international financial reporting standards (IFRSs) rather than retaining its own standard-setting mechanism. A number of reasons have been put forward for retaining the standard-setting process. First, IFRSs require modification for factors unique to New Zealand. These include legal and public-sector differences, as New Zealand is one of the few jurisdictions that issues common financial reporting standards for both its public and its private sectors (McKenzie 1997, p. 1). Second, standards could continue to be developed on subjects not dealt with in IASs, such as the requirement for a statement of service performance. Finally, political considerations would not need to be taken into account. Principles of democracy as well as the requirements of due process mandate that parties affected by accounting standards have the opportunity to present their views and have a realistic chance of influencing the final outcome.

As will be explained in further detail later in this chapter, the adoption in New Zealand of IFRSs is typically justified on the ground that should New Zealand elect to retain unique accounting standards, the inflow of foreign investment into the country would be restricted. Within Australia a similar view is promoted within the Federal Government's Corporate Law Economic Reform Program (CLERP). In CLERP's 1997 document *Accounting Standards: Building International Opportunities for Australian Business* it is stated (p. 15):

> *There is no benefit in Australia having unique domestic Accounting Standards which, because of their unfamiliarity, would not be understood by the rest of the world. Even if these standards were considered to represent best practice, Australia would not necessarily be able to attract capital because foreign corporations and investors would not be able to make sensible assessments, especially on a comparative basis, of the value of Australian enterprises. The need for common accounting language to facilitate investor evaluation of domestic and foreign corporations and to avoid potentially costly accounting conversions by foreign listed companies are powerful arguments against the retention of purely domestic financial reporting regimes.*

This view is consistent with that provided in Policy Statement 4, 'International Convergence and Harmonisation Policy' (issued in April 2002 by the AASB), which emphasised the need for international comparability of financial statements. As the policy statement notes, in paragraph 2:

> *There is considerable divergence between standards issued by national and international standard-setting bodies. The globalisation of economic activity has resulted in an increased demand for high quality, internationally comparable financial information. The AASB believes that it should facilitate the provision of this information by pursuing a policy of international convergence and international harmonisation of Australian accounting standards. In this context, 'international convergence' means working with other standard-setting bodies to develop new or revised standards that will contribute to the development of a single set of accounting standards for world-wide use. 'International harmonisation' of Australian accounting standards refers to a process which leads to these standards being made compatible with the standards of international standard-setting bodies to the extent that this would result in high quality standards. Both processes are intended to assist in the development of a single set of accounting standards for world-wide use.*

Financial Accounting in the News 1.2 details a similar view, expressed by Tim Fairhall, a past president of the New Zealand Institute of Chartered Accountants, in an article entitled 'Global companies need global accounts', which appeared in the 22 March 2000 issue of *The Independent*.

IMPACT OF ADOPTING IFRSS

The process of adopting IFRSs will lead to significant changes in some standards and minor changes in others. Areas in which significant changes will occur include (and this is by no means a comprehensive list) the following:

- The treatment of intangible assets will change dramatically. For example, such things as the costs of research, mastheads and brand names must now be expensed as incurred. Prior to the issue of NZ IAS 38 'Intangible Assets' a number of New Zealand entities capitalised and included internally generated intangible assets, including brands and mastheads, in their financial statements. The implication of adopting NZ IAS 38 is that these companies will be required to derecognise these intangible assets and remove hundreds of millions of dollars of assets from their statements of financial position.
- The revaluation of intangible assets will also be greatly restricted. Under NZ IAS 38, intangible assets may be revalued to fair value to the extent that there is an active market for such assets and that the associated prices are publicly available. However, for many intangible assets there is no 'active market'.
- Under previous New Zealand accounting standards, goodwill (also an intangible asset) was required to be systematically amortised over a period not to exceed of 20 years. Under NZ IFRS 3 'Business Combinations' systematic amortisation of goodwill is abolished and replaced by a requirement that annual tests be undertaken to determine whether the value of goodwill has been impaired (impairment testing).

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1.2 FINANCIAL ACCOUNTING IN THE NEWS

GLOBAL COMPANIES NEED GLOBAL ACCOUNTS

International financial reporting is at a crossroads. Behind the dilemma is long-standing tolerance of diverse and fiercely defended national accounting standards—standards that are increasingly irrelevant and damaging, given the global need for uniform performance measures.

The world is faced with a plethora of accounting standards ranging from those sufficiently robust to support international capital markets to those falling far short of communicating even the underlying economic reality of corporate performance.

On top [of] this are regulatory regimes ranging from the rigorous to the barely visible.

Domestic accounting rules and regulations reflect the economies, business structures and cultures of different countries. But in the world of globally traded equities, it is absurd that companies in the same industry can present completely different performance pictures merely because of the accounting framework they choose for their financial statements.

Not surprisingly, investors are ill-served by these variations. Given the increasingly global economy, the argument for one international set of accounting principles is compelling.

Cross-border mergers, acquisitions and business growth by multinationals make it important for the stock of giant organisations to be easily traded throughout the world.

A major barrier arises when a multinational that keeps its books on one accounting basis—usually following the principles of its home country—decides to register securities on an exchange that requires a different set of principles, such as those used in the United States or Britain.

The new millennium presents us with the prospect of some significant trends, such as:

- further trade liberalisation and still greater flows of capital;
- convergence of the world's major companies into a small number of global conglomerates;
- a more complicated regulatory regime to protect investors and the public interest;
- domination of capital markets by a relatively small number of huge global players who, by virtue of their size, are forced to be long-term investors;
- an increase in the demand for information and an explosion in its availability.

Continuing to rely on national rules will create confusion. High-quality, well-understood, consistently applied and transparent global accounting standards are needed.

There are two logical contenders for a common business language: US Generally Accepted Accounting Principles (US GAAP) and International Accounting Standards (IAS).

From one perspective, US GAAP has worked best—despite its complexity and rulebook nature—because of Securities and Exchange Commission (SEC) enforcement, its operation in a single and complex economy, and its support of the world's largest and strongest capital market.

On the other hand, even its most ardent admirers concede the system is too complicated. US GAAP has, for decades, clearly moved away from principles and towards detailed rules and extensive disclosures. The rules beget imaginative interpretations which, in turn, beget financial statements so extensive they are not read, let alone understood. And the 100 000 pages of tightly drawn rules are still no protection against inconsistent application, as SEC chairman Arthur Levitt observed last year.

For US standards to be transformed into global accounting principles, we need some simplification and a bit of de-tuning.

An alternative system, seeking the best in international standards, is the IAS.

The model for international harmonisation depends on mechanisms set up some 25 years ago by the International Federation of Accountants (IFAC) through its International Accounting Standards Committee (IASC) and its International Auditing Practices Committee (IAPC).

Despite legions of sceptics, the IASC has almost succeeded in developing a set of standards representing a reasonable harmonisation of international standards.

However, the IAS has not yet worked as anticipated because of gaps in the standards and the lack of a regulator.

IASC standards are only gradually being imported into domestic accounting standards, such as those in New Zealand, but certain key countries—notably Britain and the US—have chosen to stand back.

In addition, New Zealand is unique in creating a common set of standards for public as well as private sector entities. This adds a further dimension to the harmonisation issue as other standards, including IAS, apply solely to the private sector.

The US and Britain have been justified in standing apart from IAS as a stimulus for the IASC to raise its standards. However, as the gap has narrowed, these countries can and should make a more positive contribution to developing harmonised global standards by more overtly supporting IAS.

A nightmare scenario would be for the US Financial Accounting Standards Board (US FASB) to continue to do its thing, the IASC to continue to do its thing, and Britain to remain on a separate course.

Meanwhile, confidence in the reporting environment erodes worldwide, companies fail, markets fail and regulators in major capital markets legislate more special regulations.

Standards eventually revert to being more diverse from country to country because they are set by government regulators, while private standard setters strive to harmonise a morass of government standard setting and regulation.

The dream scenario is for a single global accounting standard-setting body to be established where all national standard setters participate and to which all national standard setters defer. The global standard setter is supported by a single global securities regulatory body. All standard setters pool resources and promulgate one common standard.

The big question is: how does a deliberative group really set worldwide standards?

Not by imposition. The European experience has shown that

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imposed rules based in law without regard to the market are a hindrance, not a help. Thus, national governments in Europe now allow IAS as an alternative to local domestic rules.

There needs to be a movement towards market-driven international regulation, respecting national differences but avoiding the restrictions of separate national rules.

This argues for a bigger, better and reorganised IASC promoting better standards, better interpretations, better exposure of non-compliance, mutual recognition by regulators—particularly in the USA and Britain—and without the need for reconciliations in foreign registrations.

The SEC is the key. Levitt has already announced a three-pronged test for accepting IAS standards for filing by non-US registrants based on transparency, quality and consistent implementation.

With a bit of faith from the SEC, the IAS can get a passing grade on these tests. The SEC can then propose allowing IAS for non-US domiciled companies wishing to register in the US.

The next big question for the SEC will be whether US companies can adopt IAS. The case for a common business language and common standard setting is compelling. Conditions are favourable to support a truly revamped IASC over the next few years. Global accounting standards must become a reality.

No single existing system has the monopoly on best practice.

Source:
Tim Fairhall, 'Global companies need global accounts', *The Independent*, 22 March 2000.

- Under previous New Zealand accounting standards the revaluation of property, plant and equipment was to be done by class of assets. Under IFRSs, such revaluations are to be done on an asset-by-asset basis (however, the not-for-profit sector will still be permitted to undertake revaluations by class of asset).
- Changes will also occur in the treatment of voluntary changes in accounting policy. Previously when an entity made a voluntary change in accounting policy, this was accounted for in the current period. Under NZ IFRS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', entities will be required to make retrospective adjustments of voluntary changes in accounting policies. Fundamental errors were previously corrected by making a retrospective restatement. Under NZ IFRS 8 retrospective restatements will be made to correct all material (note the change in emphasis) errors made in prior periods. In other words the financial statements will be adjusted as if the error had never occurred—meaning that opening balances will be amended in a retrospective manner.
- Under IFRSs the tests for classifying items as equity as opposed to liabilities will become more stringent, with the result that a number of items, for example convertible preference shares, that might currently be disclosed as equity will subsequently need to be disclosed as liabilities.
- The former accounting standard dealing with taxation SSAP-12 'Accounting for Income Tax' is based on a fundamentally different concept from NZ IAS 12 'Income Tax'. SSAP-12 uses the income statement liability method that focuses on timing differences and attempts to match the taxation charge with pre-tax income. NZ IAS 12 uses what is termed the balance sheet method, which focuses on temporary differences between the carrying amount of assets and liabilities in the statement of financial position and their tax base (see Chapter 18). NZ IAS 12 does not permit the use of the partial basis of accounting for deferred tax. In addition, the recognition of deferred tax assets is based on the criterion of 'probable' rather than 'virtually certain'.

For some reporting entities the impact of adopting IFRSs in the place of former accounting standards will be significant. Some organisations will have their reported profits severely reduced and their assets greatly written down as a result of applying IFRSs. This will, in turn, impact on such things as gearing ratios (which might be utilised within borrowing agreements with banks) and profit-based bonuses that might be paid to employees. Earnings per share and other indicators of performance will also be affected.

Given the magnitude of the impact of adopting IFRSs on corporate financial statements, it would be useful if reporting entities would inform financial statement readers, in advance, about the consequences of adopting IFRSs for subsequent corporate financial performance and financial position. This would potentially reduce the 'shocks' that will be felt when IFRS-compatible financial statements are issued.

To this end, in 2005 the FRSB issued FRS-41 'Disclosing the Impact of Adopting New Zealand Equivalents to International Financial Reporting Standards'. This accounting standard requires reporting entities to provide, in advance, an explanation of the impacts adoption of IFRSs will have on their financial statements. Specifically, the standard is expected to apply to quarterly, half-yearly and annual reporting periods ending on or after 30 June 2005 and ceases to operate on first-time adoption of NZ IFRS 1 'First-time Adoption of New Zealand Equivalents to International Financial Reporting Standards'. The introduction to FRS-41 states:

> *Adoption of NZ IFRSs between 2005 and 2007 may have significant impacts on the accounting policies of New Zealand entities and their reported financial position and financial performance.*

The objective of FRS-41 is detailed in paragraph 1 as requiring

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…issuers, and to encourage other entities, to disclose the impacts of adopting New Zealand equivalents to IFRSs (NZ IFRSs) including:

(a) information in respect of planning for the transition to NZ IFRSs;

(b) key differences in accounting policies expected to arise on adoption of NZ IFRSs; and

(c) known or reliably estimable information about the impacts on the financial reports had the financial report been prepared using NZ IFRSs.

In relation to the required disclosures, FRS-41, paragraph 4, requires:

In respect of financial reports for annual, half-yearly or quarterly reporting periods an entity shall disclose in its financial report:

(a) an explanation of how the transition to NZ IFRSs is being managed;

(b) (i) a narrative explanation of the key differences in accounting policies that are expected to arise from adopting NZ IFRSs; or

(ii) if the key differences in (b)(i) above are not known, a statement to that effect;

(c) (i) any known or reliably estimable information about the impacts on the financial report had it been prepared using NZ IFRSs; or

(ii) if the impacts in (c)(i) above are not known or reliably estimable, a statement to that effect; and

(d) a cautionary note to the effect that the actual impact of adopting NZ IFRSs may vary from the information presented, and that the variation may be material.

For an example of the information an entity might provide about the impact of adopting IFRSs see Exhibit 1.2, which details the disclosures made in the 2007 financial statements of Air New Zealand Limited.

While a number of countries are adopting IFRSs, the United States has not made any firm commitment to doing so. This means issues of comparability at the international level will remain. There are still differences between US generally accepted accounting principles (GAAP) and IFRSs, which will persist for some time. There is, however, a joint project between the IASB and the US Financial Accounting Standards Board, which is aiming at converging IFRSs and FASB standards, with the result that further changes in IFRSs and FASB standards are to be expected (and any changes to IFRSs will flow through to New Zealand). The document 'A Roadmap for Convergence between IFRSs and US GAAP—2006–2008 Memorandum of Understanding between the FASB and the IASB' issued on 27 February 2006 spells out that the FASB and the IASB reaffirmed their commitment to the convergence of US generally accepted accounting principles (US GAAP) and International Financial Reporting Standards (IFRSs):

After their joint meeting in September 2002, the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their Norwalk Agreement in which they 'each acknowledged their commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, the FASB and the IASB pledged to use their best efforts (a) to make their existing financial reporting standards fully compatible as soon as is practicable and (b) to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained.'

At their meetings in April and October 2005, the FASB and the IASB reaffirmed their commitment to the convergence of US generally accepted accounting principles (US GAAP) and International Financial Reporting Standards (IFRSs). A common set of high quality global standards remains the long-term strategic priority of both the FASB and the IASB.

The FASB and the IASB recognise the relevance of the roadmap for the removal of the need for the reconciliation requirement for non-US companies that use IFRSs and are registered in the United States. It has been noted that the removal of this reconciliation requirement would depend on, among other things, the effective implementation of IFRSs in financial statements across companies and jurisdictions, and measurable progress in addressing priority issues on the IASB-FASB convergence programme. Therefore, the ability to meet the objective set out by the roadmap depends upon the efforts and actions of many parties—including companies, auditors, investors, standard-setters and regulators.

The FASB and the IASB recognise that their contribution to achieving the objective regarding reconciliation requirements is continued and measurable progress on the FASB-IASB convergence programme. Both boards have affirmed their commitment to making such progress. Recent discussions by the FASB and the IASB regarding their approach to the convergence programme indicated agreement on the following guidelines:

- *Convergence of accounting standards can best be achieved through the development of high quality, common standards over time.*

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Exhibit 1.2

Impact of adopting IFRSs—2007 financial statements—Air New Zealand Limited

24. IMPLEMENTATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (NZ IFRS)

Air New Zealand Limited adopted NZ IFRS on 1 July 2007. The project to convert to NZ IFRS commenced in October 2003 and is now in the transition phase. The project is proceeding to plan. Conversion to NZ IFRS will conclude with the delivery of the first set of NZ IFRS compliant interim financial statements for the six months ending 31 December 2007 and the first set of NZ IFRS compliant annual financial statements for the year ending 30 June 2008.

This disclosure highlights the most significant changes in accounting policies expected to arise upon conversion to NZ IFRS together with the expected impacts on earnings for the year to 30 June 2007. It should be noted that further developments in NZ IFRS may result in changes to the accounting policy decisions made by directors to date and, consequently, the likely impacts outlined in the discussion below. The directors may, at any time until the completion of the Group's first NZ IFRS compliant financial statements, revisit and, where considered necessary, revise the accounting policies applied in preparing the estimates below. The estimated adjustments detailed below may be materially different from the actual adjustments.

The table below provides a summary of the potential impacts on equity resulting from conversion to NZ IFRS. The summary should not be taken as an exhaustive list of all the differences between existing NZ GAAP and NZ IFRS. Only a complete set of financial statements and notes together with comparative balances can provide a true and fair presentation of Air New Zealand's financial position, results of operations and cash flows in accordance with NZ IFRS.

SUMMARY OF THE IMPACT

AS AT AND FOR THE YEAR TO 30 JUNE	*2007 EARNINGS ($m)*	*2007 ASSETS ($m)*	*2007 LIABILITIES ($m)*	*2007 EQUITY* ($m)*	*2006 ASSETS ($m)*	*2006 LIABILITIES ($m)*	*2006 EQUITY ($m)*
NZ GAAP as reported	214	4 944	3 196	1 748	4 785	3 191	1 594
Deemed cost exemption	33	(154)	–	(154)	(187)	–	(187)
Jet aircraft residual value hedge	133	19	–	19	(102)	–	(102)
Financial instruments	(118)	22	253	(231)	165	(37)	202
Maintenance	(32)	(59)	127	(186)	(24)	130	(154)
Customer loyalty programme	9	–	50	(50)	–	59	(59)
Defined benefit plans	4	3	(1)	4	1	1	–
Share based payments	(1)	–	–	–	–	–	–
Taxation	(19)	–	(241)	241	–	(153)	153
Restated under NZ IFRS	223	4 775	3 384	1 391	4 638	3 191	1 447

All adjustments are shown before taxation.

* The IFRS adjustments in this column are stated on a cumulative basis including the transitional adjustments as at 1 July 2006 and the movements for the year to 30 June 2007.

DEEMED COST EXEMPTION

The Group has elected to apply the 'fair value as deemed cost' exemption available under NZ IFRS 1 – First Time Adoption of New Zealand Equivalents to International Financial Reporting Standards to the older generation jet aircraft and significant building assets on transition to NZ IFRS. This exemption allows entities to measure an item of property, plant and equipment at fair value at transition date, and to use that fair value as its deemed cost from that point forward.

On transition, the carrying value of the Boeing 747-400, 767-300, 737-300 fleet types and buildings associated with the New Zealand Engineering operations will be decreased by a net amount of $187 million before tax. Opening equity will be reduced by the same amount.

The impact on earnings for the year to 30 June 2007 of applying the deemed cost exemption is a decrease in depreciation expense of $33 million.

JET AIRCRAFT RESIDUAL VALUE HEDGE

Air New Zealand currently designates the USD denominated residual values of the jet aircraft fleet, engines, simulators and progress payments as a hedge of related USD denominated borrowings and finance lease liabilities. NZ IFRS does not permit such a hedge.

Therefore this accounting treatment will be reversed on transition to NZ IFRS. The impact of this reversal is a reduction in equity (before tax) of $102 million upon transition.

The impact on operating surplus before taxation for the year to 30 June 2007 of not applying the jet aircraft residual value hedge is an increase of $133 million and relates primarily to foreign exchange gains on the USD borrowings and finance lease liabilities, previously hedged by the USD denominated jet aircraft residual values. Exchange gains and losses on these USD borrowings and finance lease liabilities will be recorded in the Statement of Financial Performance under NZ IFRS, but will be substantially offset by movements in the fair value of non hedge

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Exhibit 1.2

continued

accounted foreign currency derivatives that will also be recognised in the Statement of Financial Performance and are included within the financial instruments impact shown above. In addition current year translation movements recorded within the NZ GAAP foreign currency translation reserve of $12 million are reversed under NZ IFRS.

FINANCIAL INSTRUMENTS

NZ IFRS requires the recognition of all derivatives at fair value through the Statement of Financial Performance, unless they are designated as part of a cash flow hedge. Under existing NZ GAAP, derivatives remain off balance sheet until the underlying hedged item is realised. The recognition of derivatives at fair value on transition increases net equity (before tax) by $202 million.

NZ IFRS requires strict criteria to be met in order to qualify for hedge accounting. Whilst Air New Zealand's general hedging strategies are permissible under NZ IFRS, certain changes have been made to enable these hedges to be designated as cash flow hedges. Risk management practices will continue to be determined on an economic basis, rather than being designed to achieve a particular accounting outcome. Consequently, it is expected that this will result in some transactions failing the hedge effectiveness criteria from time to time and hedging gains or losses being recorded in current period earnings. In particular given the high volatility of fuel markets, the effectiveness test may not always be met and changes in the fair value of fuel hedging instruments would then need to be recognised in the Statement of Financial Performance and consequently, some earnings volatility may arise. The accounting treatment of options under NZ IFRS will also result in ineffectiveness being recognised through earnings. Only the intrinsic value is included in the hedge designation – all other components of the option value are marked to market through earnings.

The impact on operating surplus before taxation for the year to 30 June 2007 is a loss of $118 million. This includes the change in the fair value of non hedge accounted foreign exchange contracts (substantially offsetting the exchange impact on the reversal of the jet aircraft residual value hedge above), and interest rate swaps. The impact also includes any accounting ineffectiveness on qualifying cash flow hedges of which a $1 million loss related to fuel. The fuel portion included a $31 million loss in the six months to 31 December 2006 during which hedge accounting was not applied to fuel. Hedge accounting was applied to fuel derivatives with effect from 1 January 2007.

The remaining movement in equity represents the effective gains or losses on qualifying cash flow hedges which have been recognised in the cash flow hedge reserve.

ACCOUNTING FOR MAINTENANCE

Air New Zealand currently expenses all maintenance as incurred. The application of NZ IFRS in respect of accounting for aircraft and related maintenance costs results in the following changes:

- Engines will be accounted for as a separate component of aircraft and depreciated separately. The estimated useful life of engines will be revised on transition to NZ IFRS;
- The cost of major airframe inspections and engine overhauls will be capitalised and recognised in the carrying amount of the asset. The capitalised amount will then be depreciated over the period to the next expected inspection or overhaul. On transition to NZ IFRS, the appropriate carrying value of previously expensed maintenance will be reinstated on the Statement of Financial Position; and
- Where the Group has a commitment to maintain aircraft held under operating lease arrangements, provision is made during the lease term for the lease return obligations specified within those lease agreements. The provision is based on estimated future costs of major inspections and engine overhauls by making appropriate charges to the Statement of Financial Performance calculated by reference to the number of hours or cycles operated during the year.

The overall net impact on equity of these adjustments on transition is a decrease of $154 million, before tax.

Future earnings will see a transfer from the maintenance and overhaul expense category to depreciation, and an increase in depreciation due to the revised useful life of engines. The provisioning for lease return costs will be recognised as maintenance and overhaul expense.

The overall net impact on operating surplus before taxation for the year to 30 June 2007 is a decrease of $32 million.

CUSTOMER LOYALTY PROGRAMME

IFRIC Interpretation 13 – Customer Loyalty Programmes was issued in June 2007 and requires separate recognition of award credits granted as part of an initial sales transaction. Accordingly the consideration allocated to the Group's Frequent Flyer provision will need to be measured by reference to their fair value under this Interpretation.

The Group intends to adopt IFRIC 13 early, to avoid subsequent restatement in 2009 when the Interpretation becomes effective.

The impact of adopting NZ IFRS on transition is to increase deferred revenue and decrease equity before tax by $59 million. The release to revenue in future years will be determined by the redemption profile of Airpoints. The impact on operating surplus before taxation for the year to 30 June 2007 is an increase of $9 million.

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DEFINED BENEFIT PLANS

NZ IFRS requires actuarial valuations to use a different valuation methodology and a different discount rate to that currently employed. The Group will be applying the 'corridor' approach whereby actuarial gains and losses will only be recognised to the extent that they exceed 10 percent of the greater of the scheme assets or liabilities. This excess will be spread over the remaining average service lives of the employees.

Recent debate in the international accounting arena has lead to a revision of the discount rate used to determine the present value of the defined benefit obligation on transition and going forward under NZ IFRS. The impact of the application of NZ IFRS to accounting for defined benefit schemes at transition is now zero.

The impact on operating surplus before taxation for the year to 30 June 2007 is an increase of $4 million before tax.

TAXATION

NZ IFRS requires deferred taxation to be determined using a balance sheet method as opposed to the income statement method currently employed under existing NZ GAAP. Under the balance sheet approach, income tax on the profit or loss for the year comprises both current and deferred taxation. In brief, temporary differences are differences between the carrying value of assets and liabilities for financial reporting purposes as compared to their carrying value for tax purposes. Temporary differences may give rise to deferred tax assets or deferred tax liabilities. Applying NZ IFRS at transition date results in an overall decrease in the deferred tax liability and increase in net equity of $153 million.

The overall tax impact on net earnings for the year to 30 June 2007 is an increase in the tax expense of $19 million. The remaining movement in equity in respect of taxation represents the tax on movements in the cash flow hedge reserve for the year.

SHARE BASED PAYMENTS

There is currently no guidance on how to account for share based payments under NZ GAAP. NZ IFRS 2– Share-based Payment requires equity settled transactions, such as the issue of share options to employees, to be recognised at fair value in the financial statements over the vesting period.

This results in an adjustment to opening retained earnings and issued capital of $1 million on transition and a $1 million cost in earnings in the year to 30 June 2007, although there will be no net impact on equity.

INTANGIBLE ASSETS

Air New Zealand does not currently recognise any intangible assets. NZ IAS 38–Intangible Assets and related interpretations require computer software that is not an integral part of the related computer hardware to be treated as an intangible asset, provided certain criteria are met.

On conversion to NZ IFRS, an amount of $57 million will be reclassified from tangible to intangible fixed assets. There will be no net impact on equity or earnings for the year to 30 June 2007.

- *Trying to eliminate differences between two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources—instead, a new common standard should be developed that improves the financial information reported to investors.*
- *Serving the needs of investors means that the boards should seek to converge by replacing weaker standards with stronger standards.*

This means that subsequent to the adoption of IFRSs in 2007 (2005 for early adopters) it is likely that another round of changes in accounting standards will occur as part of the process of harmonising IFRSs and standards issued by the FASB. This process has commenced with the IASB and FASB collaborating on a conceptual framework project.

All the activity arising from the harmonisation program will be time consuming and costly. Those in charge of framing the regulations will necessarily hold that there are benefits that balance or, conceivably, outweigh the costs being incurred on this exercise. On the subject of these benefits for New Zealand companies, ED-92 'Preface to Financial Reporting Standards', paragraph 5.8, claims international convergence and harmonisation will, among other things:

- improve the quality of financial reporting in New Zealand to best international practice;
- increase the comparability of financial reports prepared in different countries and provide participants in international capital markets with better quality information on which to base investment and credit decisions (it will also reduce financial analysis costs through analysts not having to recast information on a common basis and requiring knowledge of only one set of financial reporting standards rather than several);
- remove barriers to international capital flows by reducing differences in financial reporting requirements for participants in international capital markets and increase the understanding by foreign investors of New Zealand financial reports;

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- reduce financial reporting costs for New Zealand multinational companies and foreign companies operating in New Zealand and reporting elsewhere; and
- facilitate more meaningful comparisons of the financial performance and financial position of New Zealand and foreign public sector reporting entities.

All such benefits will come at a cost. That cost will include the costs of educating accountants to adopt a new set of accounting standards and the costs associated with changing data-collection and reporting systems. Such costs will be borne by large listed companies, as well as large proprietary companies, not-for-profit entities and local government. These last three categories of reporting entities are relatively unlikely to benefit from such things as increased capital inflows. Yet they will still incur significant costs.

In relation to the issue of being able to compare the financial performance of entities from different countries, it is argued that while there continue to be differences in the accounting standards issued by different countries there will continue to be difficulties in comparing the financial performance of reporting entities from different countries. The differences in accounting rules can have significant implications for profit comparisons. Consider the following statement from an article in *The Australian Financial Review* (25 November 1998):

> *From time to time, the fundamental differences in accounting and reporting standards among the various countries of the western world hit the headlines. This was never more dramatically demonstrated than when Daimler-Benz achieved a listing on the New York Stock Exchange (the first German company to do so) in October 1993.*
>
> *When the group accounts were converted from German accounting rules to US GAAP (generally accepted accounting practice), a DM168 million profit for the first half year became a staggering DM949 loss.*
>
> *More recently, German conglomerate Hoechst, which had adopted international accounting standards (IAS) in 1994, also listed in New York. In the process of reconciling its accounts with US GAAP an IAS profit of DM1.7 billion became a loss of DM57 million.*

Closer to home, the article by Finola Burke reproduced in Financial Accounting in the News 1.3, 'News learns wealthy lesson: don't move to US', which appeared in *The Australian* of 15 November 2000, illustrates how a large accounting profit, according to Australian accounting standards, became a significant loss for the Australian company News Corporation Limited once US standards were applied.

1.3 FINANCIAL ACCOUNTING IN THE NEWS

NEWS LEARNS WEALTHY LESSON: DON'T MOVE TO US

US accounting principles have turned The News Corporation Ltd's $1.92 billion net profit in fiscal 2000 into a $329 million loss, according to documents filed with the US Securities and Exchange Commission.

While the US loss does not change the profit reported by News at the end of last financial year, it does demonstrate how different News's accounts would look if it moved its headquarters to the US.

The net difference before minority interests to the way in which News reported its income last year was a $2.4 billion loss.

Under US Generally Accepted Accounting Principles (US GAAP), companies are not allowed to capitalise start-ups, book abnormal losses or gains, or revalue mastheads or television licences. Depreciation is also treated differently.

US GAAP would have had News making a loss rather than its near $2 billion profit and shaved its operating income back to $1.5 billion from the reported $2.74 billion the company made under Australian accounting rules.

Source:
Finola Burke, 'News learns wealthy lesson: Don't move to US', *The Australian*, 15 November 2000, p. 32.

Having considered how different countries' accounting rules can generate significantly different profits or losses, it would be interesting to consider whether such differences warrant all the activity that is taking place to harmonise accounting standards internationally. Certainly, this justification has been used by New Zealand accounting standard setters.

The view that harmonisation will lead to cost reductions and capital inflows into New Zealand is not one that is necessarily supported (or rejected) by any empirical data, but the NZX nevertheless holds the view that general compliance with IASB standards will lead to significant additional inflows of foreign investment. In this regard, the International Organisation of Securities Organisations (IOSCO) has contributed funds to the development of a set of international standards for international stock exchange listings. In May 2001, the IOSCO announced that it would recommend the adoption of IASC/IASB standards as a permissible basis for preparation of financial statements to member exchanges throughout the world. Such a move would mean that an organisation seeking to list its shares on another country's exchange would not need to adjust its financial statements to comply with that country's requirements as they would already comply with IASB standards.

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In considering the implications of the harmonisation program from an Australian perspective, which applies equally to New Zealand, Parker (1997, p. 48) notes that:

> *It is a significant step for Australia towards the long-term goal of a single, universal set of accounting standards which apply to all reporting entities around the world. Whether this one set of accounting standards emanates from the IASC or the IASC in co-operation with the major standard-setters remains to be seen. What is certain is that the manner in which Australian accounting standards are developed has been significantly and irrevocably changed.*

More details about IOSCO can be found on its website, which is located at <www.iosco.org>.

1.4 STRUCTURE OF THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

The International Accounting Standards Committee (IASC) was established in 1973 with the aim of bringing together parties from throughout the world to develop accounting standards that apply internationally. In January 2000, the IASC had 143 members, with representatives from the professional accounting bodies from over a hundred countries, including the United Kingdom, the US, Canada, the Netherlands, Malaysia, Germany, Japan and Australia.

In April 2001 the IASC was replaced by the IASB. The IASB is now responsible for releasing international accounting standards or, as they have now become known, international financial reporting standards (IFRSs).

Until recently, standards issued by the IASC, and subsequently by the IASB, were not of direct importance to countries that had their own standard-setting processes in place. They would, however, typically be referred to as an indication of possible best practice when accounting standards were being developed within these countries. They were also deemed to provide useful guidance when no domestic standard related to a particular accounting issue. Countries that did not have their own accounting standards in place have been known to adopt directly the standards developed by the IASC and later the IASB. This has been the case especially in developing countries. In more recent times, however, some developed countries have established programs either to adopt IFRSs or to harmonise their domestic standards with IFRSs. This is being done because of the perceived benefits associated with having globally consistent accounting standards.

As noted above, there has been a change in the parties responsible for developing international accounting standards. In essence, with the establishment of the IASB, the standard-setting structure of the IASB became very similar to the accounting standard-setting structure recently established in Australia. There is a group of trustees (similar to the FRC in Australia) made up of 19 individuals, and these trustees are responsible for the appointment of IASB members (and members of the Standing Interpretations Committee and the Standards Advisory Council). The trustees also exercise oversight over the IASB and are involved in raising the funds needed by the IASB. The trustees come from a number of different countries, with six from North America, six from Europe, four from the Asia–Pacific, and three others.

The IASB is made up of 14 individuals, 12 of whom are full time, and two part time. The website of the IASB describes how accounting standards are issued within the IASB. The website explains:

- during the early stages of a project, the IASB may establish an Advisory Committee to give advice on the issues arising in the project. Consultation with the Advisory Committee and the Standards Advisory Council (also part of the IASB) occurs throughout the project;
- IASB may then develop and publish Discussion Documents for public comment;
- following the receipt and review of comments, IASB could then develop and publish an Exposure Draft for public comment; and
- following the receipt and review of comments, IASB would issue a final International Financial Reporting Standard.

Each IASB member has one vote on technical and other matters. The publication of a standard, exposure draft or final SIC interpretation requires approval by eight (8) of the Board's fourteen (14) members. Other decisions, including the issuance of a draft statement of principles or a discussion paper and agenda decisions, require a simple majority of the Board members present at a meeting attended by 50 per cent or more of Board members. The Board has full control over its technical agenda.

When the IASB publishes a standard, it also publishes a Basis for Conclusions to explain publicly how it reached its conclusions and to give background information that might help users of standards to apply them in practice. The IASB also publishes dissenting opinions.

The IASB website details how the IASB coordinates its activities with national standard setters. The website explains that close coordination between the IASB's due process and the due process of national standard setters is important to the success of the IASB's mission. Further, according to the IASB website, the IASB is exploring ways in which it can integrate its due process more closely with national due process. Such integration might grow as the relationship between the IASB and national standard setters evolves. In particular, the IASB is exploring the following procedure for projects that have international implications:

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- IASB and national standard setters (such as the FRSB) would coordinate their work plans so that when the IASB starts a project, national standard setters would add it to their own work plans so that they can play a full part in developing international consensus. Similarly, where national standard setters start projects, the IASB would consider whether it needed to develop a new standard or revise its existing standards. Over a reasonable period, the IASB and national standard setters should aim to review all standards where significant differences currently exist, giving priority to the areas where the differences are greatest.
- National standard setters would publish their own exposure documents at approximately the same time as IASB exposure drafts and would seek specific comments on any significant divergences between the two exposure documents. In some instances, national standard setters might include in their exposure documents specific comments on issues of particular relevance to their country or include more detailed guidance than is included in the corresponding IASB document.
- National standard setters would follow their own full due process, which they would, ideally, choose to integrate with the IASB's due process. This integration would avoid unnecessary delays in completing standards and would also minimise the likelihood of unnecessary differences between the standards that result.

The IASB has a committee known as the International Financial Reporting Interpretations Committee. The IASB website states that the International Financial Reporting Interpretations Committee (IFRIC), which was reconstituted in December 2001, reviews, on a timely basis within the context of existing international accounting standards and the IASB Framework, accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus on the appropriate accounting treatment. In developing interpretations, IFRIC works closely with similar national committees. IFRIC meets about every two months. All technical decisions are made at sessions that are open to observers. IFRIC addresses issues of reasonably widespread importance, and not issues of concern only to a small set of enterprises. The interpretations cover both:

- newly identified financial reporting issues not specifically addressed in IFRSs; and
- issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance, with a view to reaching consensus on the appropriate treatment.

More information about the IASB can be found at its website at <www.iasb.org.uk>.

As indicated above, the activities of national standard setters, such as the FRSB, can impact on the activities of the IASB. For example, as well as changing New Zealand accounting standards, the adoption of IFRSs in New Zealand is expected to impact reciprocally on the development of IASB standards. In the short to medium term, it is possible that New Zealand would still need to issue domestic exposure drafts and standards on topics not covered by the IASB. It would be desirable for the FRSB, when seeking to develop a standard on topics not already covered by the IASB, to offer to develop the standard on behalf of the IASB.

Having considered the bodies responsible for developing accounting standards the discussion turns now to the framework used in developing accounting standards. Such a framework is typically referred to as a conceptual framework.

1.5 INTERNATIONAL CULTURAL DIFFERENCES AND THE HARMONISATION OF ACCOUNTING STANDARDS

As emphasised in this chapter, globally there are moves by countries to adopt international financial reporting standards rather than continue to develop accounting standards domestically. Some factors that might impact negatively on global harmonisation or convergence of accounting standards will now be considered. A number of factors could, in the short to medium term, act as barriers to harmonisation. These include the legislative differences between jurisdictions and the effects on standard setting of the different business, cultural and political environments of different countries.

One of the 'barriers' to be considered briefly here is differences in cultures. 'Culture' itself is described by Gray (1988, p. 4) as a system of societal or collectively held values, where values are defined as a broad tendency to prefer certain states of affairs over others. Perera (1989, p. 43) describes culture as an expression of norms, values and customs, which reflect typical behavioural characteristics. There are many accounting researchers (for example, Gray 1988; Perera 1989; Fechner & Kilgore 1994; and Eddie 1996) who argue that the accounting policies and practices adopted within particular countries are to some extent a direct reflection of the cultural and individual values and beliefs in those countries. That is, the values in the accounting subculture are influenced directly by society-wide values. Perera (1989, p. 43) argues that culture is a powerful environmental factor affecting the accounting system of a country and, therefore, that accounting cannot be considered to be 'culture free'. In the same vein, Gray (1988, p. 5) states:

> *the value systems of accountants may be expected to be related to and derived from societal values with special reference to work related values. Accounting 'values' will, in turn, impact on accounting systems.*

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For example, if a country is deemed to be basically conservative, the argument is that the accounting policies of that country will tend towards conservatism. Conservative accounting policies would rely on traditional measurement practices (such as historical cost) and would be more likely to be used in countries in which the society is generally classified as seeking to minimise uncertainty (Perera 1989). Gray (1988, p. 10) observes that the degree of conservatism varies from country to country, ranging from a strongly conservative approach in the Continental European countries, such as France and Germany, to a much less conservative approach in the US and the United Kingdom.

Countries might have cultural attributes that suggest they tend more towards secrecy than transparency, and their accounting disclosure requirements might reflect this cultural bias. As with degrees of conservatism, Gray (1988, p. 11) holds that the tendency to secrecy seems to vary from country to country, with lower levels of disclosure—implying greater secrecy—including instances of secret reserves, evident, for example, in the Continental European countries, compared with higher levels of disclosure in the US and the United Kingdom.

Eddie (1996) investigated the association of particular national cultural values (identified by Hofstede 1991) and consolidation disclosures made by particular entities within a number of different countries. Consolidation practices are covered in a later chapter of this text; however, at this stage consolidation can be defined simply as the practice of combining the accounts of various entities to form one set of reports. Eddie found that particular cultural values or attributes—which had been identified and measured in previous research—are significantly associated with the extent of consolidation disclosure and the degree of variation in the extent of consolidation disclosures.

If national culture has impacted on the approaches and decisions taken by accounting practitioners and accounting standard setters within their own particular countries, is it appropriate to expect different countries, with varying cultural values, to adopt internationally uniform accounting practices? Perera (1989, p. 52) considers the potential success of transferring accounting skills from Anglo-American countries to developing countries. He notes: 'The skills so transferred from Anglo-American countries may not work because they are culturally irrelevant or dysfunctional in the receiving countries' context'.

Following on from the above discussion, the issue of 'culture' and international cultural differences might have some bearing on whether the harmonisation or adoption of accounting standards on a worldwide basis is a realistic and achievable goal. Gray (1988, p. 2) states that:

> *fundamentally different accounting patterns exist as a result of environmental differences and that international classification differences may have significant implications for international harmonisation.*

Perera (1989) argues that international accounting standards themselves are strongly influenced by Anglo-American accounting models and, as such, they tend to reflect the circumstances and patterns of thinking in a particular group of countries. He argues therefore that international accounting standards are likely to encounter problems of relevance in countries with different cultural environments from those found in Anglo-American countries.

Perhaps it could be argued that with the increasing globalisation of business, international cultural differences will be reduced. Further consideration of this issue is really beyond the ambit of this book, but it is nonetheless an interesting one.

1.6 THE USE AND ROLE OF AUDIT REPORTS

Now that the discussion has covered many of the reporting requirements for general purpose financial statements, it would be useful to consider briefly the use and role of another report that typically appears in corporate annual reports—the *audit report*.

An **audit** is the independent examination of financial information of any entity—whether profit-oriented or not and irrespective of its size or legal form—where such an examination is conducted with a view to expressing an opinion on that financial information. The audit opinion is the output of the audit process and is provided in the audit report. The auditor's opinion helps to establish the credibility and reliability of the financial information in question. Users of this information, however, should not assume that the auditor's opinion is an assurance of the future viability of the entity, or of the efficiency or effectiveness with which management has conducted the affairs of the entity—it remains simply an opinion.

audit
A detailed examination of a company's financial statements and the documents that support the information contained in the annual report.

The opinion expressed by the auditors covers whether proper accounting records have been kept, whether the financial statements comply with generally accepted accounting practice and whether they give a true and fair view of the financial position, financial performance and cash flows of the entity for the year. It cannot be considered with absolute certainty that all transactions have been correctly recorded, even when the auditor provides an unqualified opinion. The auditor does not test or check all transactions; so there is always a possibility that the financial statements might be materially misstated. It is to be hoped, however, that the probability of material misstatement is kept to a low level. Exhibit 1.3 provides an example of an audit report.

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Exhibit 1.3

Independent audit report to members of the New Zealand Institute of Chartered Accountants

TO THE MEMBERS OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NEW ZEALAND (TRADING AS NEW ZEALAND INSTITUTE OF CHARTERED ACCOUNTANTS) ('THE INSTITUTE')

We have audited the financial statements on pages 41 to 58 and the Statement of Service Performance on pages 29 to 33 and 35 to 36. The financial statements provide information about the past financial performance of the Institute and Group and their financial position as at 30 June 2007. This information is stated in accordance with the accounting policies set out on pages 44 to 47. The Statement of Service Performance provides information about the past service performance of the Institute.

This report is made solely to the Members of the Institute of Chartered Accountants of New Zealand, as a body, in accordance with the Rules of the Institute of Chartered Accountants of New Zealand. Our audit has been undertaken so that we might state to the Members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Institute and Group and the Members as a body, for our audit work, for this report, or for the opinions we have formed.

EXECUTIVE BOARD'S RESPONSIBILITIES

The Executive Board is responsible for the preparation of financial statements which comply with generally accepted accounting practice in New Zealand and fairly present the financial position of the Institute and Group as at 30 June 2007 and their financial performance and cash flows for the year ended on that date. The Board is also responsible for the preparation of the Statement of Service Performance which fairly presents the service performance of the Institute and Group for the year ended 30 June 2007.

AUDITOR'S RESPONSIBILITIES

It is our responsibility to express an independent opinion on the financial statements and Statement of Service Performance presented by the Executive Board and report our opinion to you.

BASIS OF OPINION

An audit includes examining, on a test basis, evidence relevant to the amounts and disclosures in the financial statements and Statement of Service Performance. It also includes assessing:

- the significant estimates and judgements made by the Executive Board in the preparation of the financial statements and the Statement of Service Performance; and
- whether the accounting policies are appropriate to the Institute's and Group's circumstances, consistently applied and adequately disclosed.

We conducted our audit in accordance with generally accepted auditing standards in New Zealand. We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and Statement of Service Performance are free from material misstatements, whether caused by fraud or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the Statement of Service Performance.

Certain partners of Ernst & Young have presented for the Institute during the year and serve on various Boards of the Institute. In addition to this Ernst & Young partners and employees may deal with the Institute and Group on normal terms within the normal course of membership and trading activities.

Except as stated above and other than in our capacity as auditor we have no other relationships with, or interest in, the Institute or Group.

UNQUALIFIED OPINION

We have obtained all the information and explanations we have required.

In our opinion

- the financial statements on pages 41 to 58:
  - comply with generally accepted accounting practice in New Zealand; and
  - fairly present the financial position of the Institute and Group as at 30 June 2007 and their financial performance and cash flows for the year ended on that date.
- the Statement of Service Performance of the Institute on pages 29 to 33 and 35 to 36 fairly reflects the service performance measures in relation to the strategic objectives adopted for the year ended 30 June 2007.

Our audit was completed on 6 September 2007 and our unqualified opinion is expressed as at that date.

Ernst & Young
Wellington

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In the private sector, decisions relating to the internal affairs of an enterprise, as well as lending and investment decisions of creditors and investors, must be made daily. In the public sector, interested parties must decide whether managers are complying with the controls imposed upon them and whether the entity is operating efficiently and effectively. Therefore, managers must collect and report financial information about the entity that summarises and communicates the results of their activities to interested groups. To do this, they must identify user needs for the purpose of establishing the nature of the data to be communicated—that is, decisions must be made as to what is material.

It should be remembered that the auditor is not responsible for the preparation of the financial information; that responsibility rests with management and ultimately with the directors. The auditor's responsibility is to form and express an opinion on the financial information. Arguably, the Auditor's Report is the first item a reader should review when looking at an annual report. A review of the audit report might indicate that the accounts have not been properly prepared and, perhaps, that they should not be relied upon for making resource-allocation decisions.

Preparers of financial information include the financial managers of enterprises, each of whom might, at times, place primary importance on maximising their own welfare. This frequently results in the goals of the persons preparing the financial information being different from the goals of those using it. This conflict, which will be further considered in the next chapter, might cause the preparers of financial information to intentionally or unintentionally introduce misstatements (or bias) into the financial data. Because of the potential bias of management in identifying and presenting such information, there is a need for independent verification of the financial data to assure fairness of presentation.

The users of financial reports need their information to be unbiased in order to reduce the information risk they face—that is, the risk of using materially misstated information—when making economic decisions. An independent auditor's task is to reduce the potential bias and error that the preparers of financial reports might introduce. The reduction (or elimination) of bias makes it a 'fairer game' for investors and creditors. When using unbiased financial information, users have a fairer chance of earning reasonable returns for their investment. With biased information, they might be forced into making inappropriate investment decisions.

To reduce this risk, users of financial statements are willing to incur an audit fee in return for some assurance that the financial statements are fairly presented. The managers of business entities are also generally prepared to subject their financial operations to audits. Potential investors are thus able to monitor past and future performance in a more reliable manner, which might motivate them to invest more funds at a lower required rate of return than would otherwise be required. Of course, the value of the independent audit is tied to the reputation of the firm performing the audit.

The requirements for an audit are set out in both the *Financial Reporting Act 1993* and the *CA*. Section 196 of the *CA* requires an auditor to be appointed by all companies except non-issuer companies who have obtained a unanimous shareholder approval to waive this requirement. Section 15 of the *FRA* requires the financial statements of all issuers to be audited. Government departments, SOEs, Crown entities, statutory authorities and municipalities and regional councils all have their financial statements audited.

1.7 ALL THIS REGULATION—IS IT REALLY NECESSARY?

As preceding sections of this chapter have discussed, financial accounting in New Zealand is fairly heavily regulated compared with other countries. There are numerous *Financial Reporting Act 1993* and *CA* requirements, and there are many accounting standards, with additional standards being issued fairly frequently. But is all this regulation really necessary? What if there were no accounting standards, and reporting entities could report whatever information they wanted in whatever format they considered appropriate?

Opinions on the need for regulation vary, and range from the 'free-market' perspective to the 'pro-regulation' perspective. Some arguments for and against regulation will be briefly considered here—for a more detailed discussion, refer to a text dedicated to financial accounting theory.

THE 'FREE-MARKET' PERSPECTIVE

Proponents of a free-market perspective on accounting regulation often believe that accounting information should be treated like other goods, with demand and supply forces being allowed to operate to generate an optimal supply of information about an entity. A number of arguments are advanced in support of their claims. One argument, based on the work of authors such as Jensen and Meckling (1976), Watts and Zimmerman (1978), Smith and Warner (1979) and Smith and Watts (1982), is that even in the absence of regulation, there are private economics-based incentives for the organisation to provide credible information about its operations and performance to certain parties outside the organisation, otherwise the costs of the organisation's operations would rise. This view is based on a perspective that the provision of credible information allows other parties to monitor the activities of the organisation. Being able to monitor the activities of an entity reduces the risk associated with investing in the entity, and this in turn should lead to a reduction in the cost of attracting capital to the organisation.

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It has also been argued that there will often be conflicts between various parties with an interest in an organisation, and accounting information will be produced, even in the absence of regulation, to reduce the effects of this conflict. For example, if an owner appoints a manager, the owner might be concerned that the manager will not serve the interests of the owner. To align the interests of the two parties, the manager might be provided with a share of profits, meaning that the manager will work hard to increase profits, with higher profitability also being in the interests of the owner. To determine profits, accounting reports will be produced, and owners will demand that these reports be produced in an unbiased manner. As discussed in the following chapter, there is also an argument that accounting reports can be used to reduce the conflict that might arise between managers and the providers of loans (debt holders). This is consistent with the usual notion of 'stewardship', according to which management is expected to provide an account of how it has utilised the funds that it has been provided with.

Further, depending on the parties involved and the types of assets in place, it has been argued that managers of the organisation will be best placed to determine what information should be produced to increase the confidence of external stakeholders (thereby decreasing the organisation's cost of attracting capital). Regulation that restricts the available set of accounting methods (for example, banning a particular method of amortisation that was used previously by some organisations) will decrease the efficiency with which information will be provided. It has also been argued that certain mandated disclosures will be costly to the organisation if they enable competitors to take advantage of certain proprietary information. Hakkanson (1977) used this argument to explain costs that would be imposed as a result of mandating segment disclosures.

While this discussion is about providing financial statements, a related issue is that of external auditing of such reports. It has been argued that even in the absence of regulation, external parties would demand that financial statement audits be undertaken. If such audits were not undertaken, financial statements would not be deemed to have the same *credibility* and, consequently, less reliance would be placed on them. If reliable information is not available, the risk associated with investing in an organisation might be perceived to be higher, and this could lead to increases in the cost of attracting funds to the organisation. It has therefore been argued that managers would have the reports audited even in the absence of regulation (Watts 1977; Watts & Zimmerman 1983; Francis & Wilson 1988). That is, financial statement audits can be expected to be undertaken even in the absence of regulation, and evidence indicates that many organisations did have their financial statements audited prior to any legislative requirements to do so (Morris 1984). However, as Cooper and Keim (1983, p. 199) indicate, for auditing to be an effective strategy for reducing the costs of attracting funds, 'the auditor must be perceived to be truly independent and the accounting methods employed and the statements' prescribed content must be sufficiently well-defined'.

There is also a perspective that holds that even in the absence of regulation, organisations would still be motivated to disclose both good and bad news about an entity's financial position and performance. Such a perspective is often referred to as the 'market for lemons' perspective (Akerlof 1970), the view being that in the absence of disclosure the capital market will assume that the organisation is a 'lemon'. (Something is a lemon if it initially appears or is assumed, perhaps owing to insufficient information, to be of a quality comparable to other products, but later turns out to be inferior. Acquiring the 'lemon' will be the result of information asymmetry in favour of the seller.) That is, no information is viewed in the same light as *bad information*. Hence, even though the firm might be worried about disclosing bad news, it is assumed that the market might make an assessment that silence implies that the organisation has very bad news to disclose (otherwise, it would disclose it). This 'market for lemons' perspective provides an incentive for managers to release information in the absence of regulation, as failure to do so will have its own implications for the organisation. That is, 'nonlemon owners have an incentive to communicate' (Spence 1974, p. 93).

Drawing upon arguments such as those adopted in the lemons argument above and applying them to preliminary profit announcements, Skinner (1994, p. 39) states:

> *Managers may incur reputational costs if they fail to disclose bad news in a timely manner. Money managers, stockholders, security analysts, and other investors dislike adverse earnings surprises, and may impose costs on firms whose managers are less than candid about potential earnings problems. For example, money managers may choose not to hold the stocks of firms whose managers have a reputation for withholding bad news and analysts may choose not to follow these firms' stocks … Articles in the financial press suggest that professional money managers, security analysts, and other investors impose costs on firms when their managers appear to delay bad news disclosures. These articles claim that firms whose managers acquire a reputation for failing to disclose bad news are less likely to be followed by analysts and money managers, thus reducing the price and/or liquidity of their firms' stocks.*

Reviewing previous studies, Skinner (1994, p. 44) goes on to note that there is evidence that managers disclose both good and bad news forecasts voluntarily. These findings are supported by his own empirical research, which shows that when firms are performing well, managers make 'good news disclosures' to distinguish their firms from those doing less well, and when firms are not doing well, managers make pre-emptive bad news disclosures consistent with 'reputational effects' arguments (p. 58).

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Arguments that the market will penalise organisations for failure to disclose information (which might or might not be bad) of course assume that the market knows that the manager has particular information to disclose. This expectation might not always be that realistic, as the market will not always know that there is information available to disclose. That is, in the presence of information asymmetry (which means that information is not equally available to all—perhaps the manager will have access to information that is not available to others), the manager might know of some bad news, but the market might not expect any information disclosures at that time. However, if it does subsequently come to light that news was available that was not disclosed, one could perhaps expect the market to react (and in the presence of regulation regulators could be expected to react as failure to disclose information in a timely manner might be in contravention of particular laws). Also, at certain times, withholding information (particularly of a proprietary nature) could be in the interests of the organisation. For example, an organisation might not want to disclose information about certain market opportunities for fear of competitors utilising such information.

So, in summary of this point, there are various arguments or mechanisms in favour of reducing accounting regulation, as even in the absence of regulation firms have incentives to make disclosures. Consideration will now be given to some alternative arguments in favour of regulating the practice of financial accounting.

THE 'PRO-REGULATION' PERSPECTIVE

A number of reasons that have been proffered in favour of reducing or eliminating regulation have been considered. One of the most simple of arguments is that if somebody really desired information about an organisation, they would be prepared to pay for it (perhaps in the form of reducing their required rate of return) and the forces of supply and demand should operate to ensure an optimal amount of information is produced. Another perspective is that if information is not produced, there will be greater uncertainty about the performance of the entity and this will translate into increased costs for the organisation. With this in mind, organisations would, it is argued, elect to produce information to reduce costs. However, arguments in favour of a 'free market' rely on users paying for the goods or services that are being produced and consumed. Such arguments can break down when we consider the consumption of 'free' or 'public' goods.

Accounting information is a public good: once it is available people can use it without paying and can pass it on to others. Parties that use goods or services without incurring some of the associated production costs are referred to as 'free riders'. In the presence of free riders, true demand is understated because people know they can get the goods or services without paying for them. Few will have an incentive to pay for the goods or services as they can be relatively confident of being able to act as free riders. This dilemma, it is argued, decreases the incentive for producers of the particular good or service, which in turn leads to an underproduction of information. As Cooper and Keim (1983, p. 190) state:

> *Market failure occurs in the case of a public good because, since other individuals (without paying) can receive the good, the price system cannot function. Public goods lack the exclusion attribute, i.e. the price system cannot function properly if it is not possible to exclude non-purchasers (those who will not pay the asked price) from consuming the good in question.*

To alleviate this underproduction, regulation is argued to be necessary to reduce the impacts of market failure. In relation to the production of information, Demski and Feltham (1976, p. 209) state:

> *Unlike pretzels and automobiles, [information] is not necessarily destroyed or even altered through private consumption by one individual … This characteristic may induce market failure.*
>
> *In particular, if those who do not pay for information cannot be excluded from using it and if the information is valuable to these 'free riders', then information is a public good. That is, under these circumstances, production of information by any single individuals or firm will costlessly make that information available to all … Hence, a more collective approach to production may be desirable.*

While proponents of a free-market approach argue that the market, on average, is efficient, it can also be argued that such 'on-average' arguments tend to ignore the rights of individual investors, some of whom might lose their savings as a result of relying upon unregulated disclosures.

In addition, whether an individual is able to obtain information about an entity might depend on the individual's control of scarce resources required by the entity. Although an individual might be affected by the activities of an organisation, without regulation and without control of significant resources, the individual might be unable to obtain the required information.

Regulators often use the 'level playing field' argument to justify putting legislation in place. From a financial accounting perspective, everybody should (on the grounds of fairness) have access to the same information. This is the basis of laws that prohibit insider trading and that rely upon an acceptance of the view that there will not be, or perhaps should not be, transfers of wealth between parties that have access to information and those that do not. There is also a view (Ronen 1977) that extensive insider trading will erode investor confidence to such an extent that market efficiency will be impaired. Putting in place greater disclosure regulations will make external stakeholders more confident that they are on a 'level playing field'. If

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the community has confidence in the capital markets, regulation is often deemed to be in 'the public interest'. However, the issue of what is the socially right level of regulation will always be a tricky one. Such a question cannot be answered with any degree of certainty. Regulation might also lead to uniform accounting methods being adopted by different entities, and this in itself will enhance the comparability of organisational performance.

Since only a fairly brief overview of the free-market versus regulation arguments has been provided, it should perhaps be stressed that this debate is ongoing with respect to many activities and industries, with various vested interests putting forward many different and often conflicting arguments for or against regulation. The subject often gives rise to heated debate within many economics and accounting departments throughout the world. Readers would do well to reflect on their own views on the matter. Should financial accounting be regulated and, if so, how much regulation should there be?

While the merits or otherwise of accounting regulation can be argued, the current extent of regulation can reasonably be expected to be at least maintained and probably increased in the future.

SUMMARY

The chapter provided an overview of the sources of regulation and guidelines relating to financial reporting within New Zealand. As has been indicated, recent years have seen major changes in the accounting standards being used within New Zealand. While New Zealand used to have a system under which accounting standards were predominantly developed domestically, as of 2005 a new system was introduced under which New Zealand accounting standards are those developed by the International Accounting Standards Board. Therefore, the relevance of the International Accounting Standards Board to New Zealand financial reporting has increased significantly in recent years.

There are numerous rules relating to external reporting. The body of rules is frequently amended, and therefore accountants in practice (and academia) must continually update their knowledge of the rules. In this regard, members of the New Zealand Institute of Chartered Accountants are required to undergo continuing professional education throughout the period of their professional membership.

KEY TERMS

Accounting Standards Review Board (ASRB)	8	general purpose financial statements	3
audit	27	New Zealand Exchange (NZX)	14
conceptual framework	5	reporting entity	4
director	6	special-purpose financial report	3
Financial Reporting Order	10	true and fair view	6
Financial Reporting Standards Board (FRSB)	11		

END-OF-CHAPTER EXERCISE

At the end of each chapter of this book, an exercise will be set that addresses particular issues raised within the chapter. Generally, these exercises will be of a practical nature requiring calculations. However, in some chapters, such as this one, a number of questions of a more theoretical nature will be posed and no answers will be provided. In fact, for some questions there is no single right answer, as any response will be dependent on subjective judgments and personal opinion. The reader is encouraged to contemplate, independently, the various factors that should be considered in answering the questions.

1. What is a general purpose financial report, and who are the users of such reports?
2. Are some users of general purpose reports more important than others? How would such an assessment be made?
3. What are the various sources of financial accounting regulation? Is financial accounting overregulated or underregulated? Why?
4. From the accountant's perspective, what does 'true and fair' mean? Is the true and fair requirement useful, or necessary?
5. How does the NZ Framework contribute to the practice of financial accounting?
6. New Zealand recently underwent a process of adopting IFRSs. What did this process actually involve, and what are some arguments for and against the initiative?

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REVIEW QUESTIONS

1 Describe the roles of the ASRB, the FRSB, the New Zealand Securities Commission and the NZX and the relationships between these regulatory bodies.
2 What is the IASB and how does it affect financial reporting regulation in New Zealand?
3 What is the role of the independent auditor, and why would the manager or the users of financial statements be prepared to pay for the auditor's services?
4 Is a conceptual framework needed in New Zealand? Why?
5 Define the elements of financial statements as per the 'Framework for the Preparation and Presentation of Financial Statements' (the NZ Framework).
6 Define 'relevance' and 'reliability'. Is there a trade-off between the two?
7 With all the regulations that companies must follow, fulfilling the requirement for corporate reporting is an additional expensive activity. What are some possible arguments for and against this regulation?
8 Define 'generally accepted accounting practice'.
9 How are international accounting standards developed and revised? Explain the role of the FRSB in that process.
10 Identify and explain some of the perceived shortcomings of the NZ Framework.
11 What are the functions of the IASB?
12 What are some of the possible cultural impediments to the international harmonisation of accounting standards?
13 Financial Accounting in the News 1.4 is an article by Mike Ross entitled 'Global economy rewrites the balance sheets' that appeared in the 11 February 2000 issue of *The National Business Review*. In this article some of the benefits of adopting accounting standards that are recognised internationally are presented. Read Financial Accounting in the News 1.4 and answer these questions:
   (a) What benefits are there for a company that adopts internationally recognised accounting standards in the preparation of its financial statements?
   (b) Obtain the article by Robert Anthony and discuss whether his contention that 'the balance sheet [statement of financial position] tends to get elevated to a god-like status' can be justified.
14 Identify major changes to financial reporting practice and financial reporting regulation that are expected as a result of the adoption of international financial reporting standards.

1.4 FINANCIAL ACCOUNTING IN THE NEWS

GLOBAL ECONOMY REWRITES THE BALANCE SHEETS

Annual accounts published by European and Asian companies are often dismissed as cosmetic whitewash, designed for show rather than substance.

German companies in particular are notorious for burying huge hidden reserves in their financial statements, allowing management to borrow from hidden piggy banks in bad years to smooth company profits. Many Asian companies have yet to fully account for the savage drop in asset values over recent years.

Managers of these companies have much in common with Grigori Alexsandrovich Potemkin, lover of Catherine the Great. He lives on, forever associated with Potemkin villages: named after his practice of having temporary villages built across the Russian steppes, many no more than a flimsy facade, intended to impress his royal lover as she made regal progress across her empire.

Potemkin financial statements also serve to flatter. Asset values are fiddled, liabilities suppressed and profitability manipulated.

A complete change of accounting culture is forced on some corporate behemoths when they outgrow their domestic capital market and have to go searching offshore for funds.

Before its merger with Chrysler, Daimler dipped its toe into the US capital markets in search of further funds for expansion. Raising funds in the US meant playing by US rules. That meant redrafting its financial statements to comply with US accounting rules.

Daimler had to come clean on the extent of its previously hidden reserves. But greater clarity in its financial statements allows Daimler to borrow more cheaply on US capital markets.

Reducing costs boosts shareholder wealth, so companies now prowl the world's capital markets looking for ways to prune a few basis points off the cost of financing.

A revolution in capital markets has spawned a subsidiary revolution in financial reporting. The commercial demand is for a set of uniform rules to govern financial reporting in all jurisdictions.

No two countries have identical rules for financial reporting.

Some are similar New Zealand along with Australia, Canada, the US and the UK share a common legal and commercial heritage and each has similar rules for financial reporting.

Some have none. Civil society has broken down to such an extent in parts of Africa that any tradition of financial reporting left by European colonists is no longer applied.

Some see no need for financial reporting. If the state owns all, as claim good socialists in Vietnam or North Korea, why bother with financial reporting?

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The quick fix is to force all countries to adopt financial reporting rules imposed by the US—the accounting equivalent of Argentina, Ecuador and Hong Kong promising their local currency is freely convertible to the US dollar at a fixed rate.

But not even all Americans agree with their own financial reporting rules, let alone wish to force the rest of the world into line. The latest issue of *Pacific Accounting Review* looks forward to how financial rules might be standardised, or even if a universal approach is possible.

The tone of the debate is set early on by Harvard Business School professor Robert Anthony, who tears strips off the US Financial Accounting Standards Board (FASB) for getting the basics wrong. He detests the emphasis given to the balance sheet in conventional accounting.

The balance sheet tends to get elevated to a god-like status, which too often gets misleadingly interpreted as a statement of the company's value. It isn't. It is a hotchpotch of figures that represent costs.

Professor Anthony also rips into the income statement, criticising the lack of useful definitions for 'income' and 'expense'. He calls for the cost of equity capital to be explicitly included in the income statement.

These are radical moves, more an economic approach than an 'add-up-the-numbers' bean-counter approach. Accounting concepts and accounting principles have grown out of commercial practice and local custom. They do not adapt quickly to a changing environment.

Rice University's Stephen Zeff points out that current rules evolved in the wake of the industrial revolution—that is back in the horse and buggy days.

He supports layers of information being disclosed in financial statements, since it is not possible to give a single overall 'black and white' picture.

Using this approach, extra information can be provided in schedules to the financial statements. This can accommodate companies wanting to report the value of internally-generated brands, or the increased value of land and buildings or potential environmental liabilities.

Over time, these disclosures become more common and become standardised. Common practice can then elevate these disclosures from attached schedules to line disclosure in the financial statements.

PricewaterhouseCoopers chairman Nicholas Moore also wants to see financial reporting becoming more flexible.

The 'one-size-fits-all' approach doesn't fit all businesses. In particular, the rules do not fit the service sector where knowledge and innovation are important—not bricks and mortar.

Financial reporting does not acknowledge their key indicators of company value: brain power and market share. He wants a common international accounting framework, but it must be flexible.

Source:
Mike Ross, 'Global economy rewrites the balance sheets', *The National Business Review*, 11 February 2000.

CHALLENGING QUESTIONS

15 After the Financial Reporting Standards Board decided to base future New Zealand financial reporting standards on International Accounting Standards Board pronouncements, the issue of ED-87 'Accounting for Intangible Assets' caused disagreement even within the ranks of the Financial Reporting Standards Board. This is shown in the article in Financial Accounting in the News 1.5 entitled 'Barons call accounting standard crazy', which appeared in *The National Business Review* on 4 June 1999. Read Financial Accounting in the News 1.5 (opposite) and answer these questions:

(a) Where there is disagreement between members of the Financial Reporting Standards Board on a proposed financial reporting standard such as the one on intangible assets, is it feasible for New Zealand to develop its own standard, even though the standard might be inconsistent with those issued internationally?

(b) Does the fact that a company like Lion Nathan Limited places a value on their beer brands in their financial statement while a company in the same industry, like the DB Group, does not place a value on their beer brands affect the comparability of the financial statements?

16 The harmonisation of New Zealand financial reporting standards with those issued by either the International Accounting Standards Committee or the Australian Accounting Standards Board has not received universal support from preparers of financial statements. In Financial Accounting in the News 1.6 entitled 'When is an asset not an asset?', which appeared in the 1 December 1999 issue of *The Independent*, Felicity Anderson discusses the issue of intangible assets. Read Financial Accounting in the News 1.6 (overleaf) and answer these questions:

(a) Using the NZ Framework definition of an asset, discuss whether internally generated assets such as brands can correctly be classified as an asset and recognised in the statement of financial position.

(b) Can financial statements that contain an internally generated intangible asset, such as a brand or masthead, in the statement of financial position be said to present a 'true and fair' view?

17 Visit the website of a company listed on the NZX. Review the company's corporate governance disclosures and determine whether the company complies with the '10 Essential Principles of Corporate Governance' identified by the New Zealand Securities Commission. If the company discloses non-compliance, evaluate the reasons provided for non-compliance.

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1.5 FINANCIAL ACCOUNTING IN THE NEWS

BARONS CALL ACCOUNTING STANDARD CRAZY

'Ridiculous,' growls *Independent Newspapers Limited* chief financial officer Randall Burt. 'Crazy,' snorts Deloitte Touche Tohmatsu partner Gavin Leake. 'Nuts,' huffs Berkshire Hathaway's Warren Buffett.

What's got these chaps steamed up? No, not a suggestion company taxes be levied at 98%. Just a proposed new international accounting standard, IAS 38.

It's not the sort of thing that normally makes headlines but this one has split the accounting profession and drawn fire from business barons around the world.

It's up for discussion here as the New Zealand Institute of Chartered Accountants' exposure draft 87, and if it's adopted it could slash billions from companies' balance sheets and tens of millions from their reported profits.

ED 87 is a photocopy of IAS 38, a standard that had a protracted and difficult gestation period. Those pushing it here are pursuing the laudable but tricky goal of harmonising worldwide the way companies report their financial affairs.

So far its progress has caused only skirmishing. But up in the hills big battalions are mobilising.

Powerful factions feel accounting standards are heading in a different direction to commercial and economic reality and IAS 38 may well be the battleground on which the utopians and the pragmatists clash decisively.

To non-accountants the proposal sounds innocuous enough. In essence companies will not be allowed to carry the value of intangible assets, brands and mastheads, trademarks, databases, licences and the like in their balance sheets unless they can be 'reliably' valued. Where the value of such assets is recognised it will have to be amortised (written off) over a period of 20 years at the most unless a strong case can be made for a longer period.

Valuations will be reliable only where the assets have a purchase price or where there is an active market to refer to. Internally generated brands won't count. Those provisions found their way into the international standard and are being sponsored here by a school of accounting thought that feels companies have got away for too long with carrying 'candyfloss' in their balance sheets, and have never had the discipline to value intangibles properly.

The school further argues accountants have allowed companies to get away with 'dubious' practices.

One is cash-stripping under-geared firms after a takeover, classic local examples being Ernest Adams and Wilson and Horton. Buy in, pay yourself a big special dividend, replace the cash with debt, and restore your debt-to-shareholder's funds ratio by sticking some intangibles into the balance sheet.

Another much-quoted example is Australia's Burns Philp, where the inclusion of insupportable trade-name values in the balance sheet led in part to the $A700 million 1997 asset write-down.

So what's the fuss about? If the standard is adopted companies' accounting ratios may change but their business fundamentals won't be affected. Analysts and institutions these days value firms on their cash flows. In any case, the argument goes, if companies feel assets which do not make the grade for inclusion should nonetheless be recognised by the market they can give off balance sheet valuations in the notes to the financial statements, as Telecom does.

Critics argue the candyfloss is in proponents' heads. Take Lion Nathan. The brewer is still assessing the situation but some hundreds of millions of dollars' worth of its brands have been bought. Last year's bill for amortisation was $15.7 million and this would swell enormously if the brands had to be written down each year, chopping substantially into reported profit.

Will investors really become adept at factoring this in when comparing Lion with other local companies? Or, given some countries are varying international standards or ignoring them altogether, with brewers in jurisdictions where IAS 38 is not in force? Forget it, say critics.

The 20-year amortisation provision is also under fire. Many of INL's mastheads have been around for a hundred years, argues Randall Burt. INL certainly hopes they will be around for another hundred.

What about Baycorp? Much of the value in its balance sheet is in the database. How about Restaurant Brands?

And how did the standard's authors come up with the 'reliability' definition?

Firms like the multinational Interbrand, which values Lion's brands, and Australia's Hambros, which values INL's mastheads, can't be too happy they are not to be considered reliable even though land and buildings valuers are. Or look at financial instruments such as shares in unlisted companies.

Even where there is no market value, under the proposed standard a discounted cash flow valuation will do.

The row over IAS 38 has factions pitted against each other within policymaking bodies and even within firms.

On the 12-member Financial Reporting Standards Board which rules in New Zealand, chairman Liz Hickey of Ernst & Young and KPMG's Joanna Perry are backing ED 87. KPMG's Andrew Dinsdale and Deloitte's Gavin Leake are opposed.

So is Ruth Picker, Liz Hickey's counterpart at Ernst & Young Australia.

Underlying the fuss is a fundamental debate about how well the accounting profession is serving the business and financial communities.

It makes a lot of sense to harmonise standards globally and many of the arguments against IAS 38 would become irrelevant if the standard applied in every jurisdiction. But that's a long way off. In the meantime countries that enforce it could lose out substantially to those that don't. Whether it should be on the books at all is a moot point. In the information economy the fastest growing industries are those in which intellectual property is companies' greatest, if not only, asset. What's the value of Microsoft without Windows?

Sponsors feel companies have got away too long with candyfloss in their balance sheets.

Source:
'Barons call accounting standard crazy', *The National Business Review*, 4 June 1999.

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1.6 FINANCIAL ACCOUNTING IN THE NEWS

WHEN IS AN ASSET NOT AN ASSET?

Lion Red, the brand, not the beer, is worth $2.2 billion according to Lion Nathan's balance sheet. Unlike the beer, the brand is an intangible asset and, as such, hard to pin a price tag on. Like a newspaper's masthead, Lion's brand is worth something. Few would argue with that. Certainly not Telecom, which values its own brands at $3 054 million, or INL, which values its mastheads at $746 million.

In contention is how Lion's brand—and others—should be valued.

This argument—how brands should appear on the balance sheet—is expected to go into abeyance for several months after submissions on draft reporting standard ED-87 closed yesterday.

Lion Nathan reckons a decision may take longer.

Warwick Bryan, Lion's manager of investor relations, sees a push for trans-Tasman consistency on the issue. Australia trails NZ in producing a standard consistent with the International Standard on Intangible Assets (No. 38)—on which our own ED-87 is based.

Thus, our Institute of Chartered Accountants may have to delay its decision.

Liz Hickey, chair of the Institute's Financial Reporting Standards Board, has said deliberations may take a year.

If ED-87 is adopted, the Lion Red brand, and others, will be worth less on company balance sheets. According to the draft standard, the value of brands that are bought and sold can be represented on the balance sheet, but not internally generated brands.

Bryan says that means two thirds of the brands would have to be immediately removed from Lion's balance sheet and the remainder would have to be removed over 20 years through amortisation.

While that will not affect cash flow, Lion hopes it will not have a negative affect on the international market perception of its financial strength. It still believes its brands are its most valuable assets and that the cost of building those brands should be recorded.

The chartered accountants' draft drew flak from the Advertising Agencies Association (3As), which is acting as lead submitter for the Marketing Council Group. David Innes, executive director of the 3As, says recognising internally generated brands, mastheads, publishing titles and even relevant customer lists as intangible assets is unfair to companies that spent a lot of time and money building brand awareness.

'Brand recognition has a value in the corporate environment,' Innes says.

'Independent Newspapers (INL) values its mastheads at $746 million, while Telecom includes a note in its financials that the Telecom brand is worth $3.054 billion as at March 1998.' Telecom does not include the value of its brands on the balance sheet because it is American owned, Innes says.

The practice of including intangibles got a bad reputation in the US in the 1980s when corporate raiders and asset strippers targeted brand-rich companies. However, British reporting standards could be used as a model for this country.

INL's finance director, Randall Burt, says the company's net assets were valued at $7.28 a share, but would be written down to $2–$3 a share if it had to remove the masthead values.

Innes says the marketing council group, which includes media, the Association of New Zealand Advertisers, Association of Market Research Organisations and others like the tertiary education sector, are opposed to the draft.

'In general terms, our opposition is based on the view that the proposed change flies in the face of economic reality,' he says.

'When a company is heavily dependent on brands, most of this viability will be represented by the ongoing attractiveness of these brands to consumers.' The 3As says in 1998 tangible assets represented only approximately 29% of the market value of Britain's FTSE 100 companies.

'The adoption of ED-87 would create a view of a company's net worth that differs from the established market and today's economic reality.' As a result, our industries would face greater competition for investment dollars in the international market place. Innes says in that environment, especially competing against the Australian debt and equity markets, New Zealand companies would be disadvantaged, facing a higher cost of capital.

The 3As' submission says the idea that only brands valued through a buy and sell process should make it to the balance sheet is 'oxymoronic'. The whole point of buying a brand is to purchase something with potentially enduring, or increasing, value.

Innes says this proposal also incorrectly suggests there are no other reliable means of establishing a brand's value. He points to two international companies—Brand Finance and Interbrand—as examples of the work being done in the area. They have conducted brand valuations for clients across a wide range of sectors, including telecommunications, banking, alcoholic drinks and retail. Those valuations are used externally for mergers, acquisitions, transfers of assets, lending, tax, litigation, and for internal marketing budget allocation, pay-back modelling, portfolio reviews and rationalisation.

Brand Finance is the incumbent brand valuation consultant for Shell, Heineken and British Telecom. Lion uses Interbrand. It reported in August that the beer brands had been valued at their current use to the business. The basis used for the valuations was to forecast future brand cash flows.

Interbrand says three steps are needed to calculate brand value:

- financial analysis to identify the earnings from the business;
- market analysis to identify the role of branding in the business;
- brand analysis to assess the strength of the brand in the market.

The 3As believes intangible assets should be subject to the same recognition criteria as tangible assets where they can be measured with reliability. It points to the New Zealand Institute of Valuers' role and argues the same approach can be taken with brands using already existing standard accounting practice.

The Financial Standards Reporting Board should look to Britain as a precedent, Innes says.

The UK FRS10 standard states an asset can be defined as such if it can be sold separately without disposing of the business as a whole, or is identifiable by the way it is controlled.

'Since the UK classes brands as being capable of being reliably measured and as an identifiable resource, we are well able to follow their lead.' The 3As also believes intangible assets should be subject to annual review.

Source:

Felicity Anderson, 'When is an asset not an asset?', *The Independent*, 1 December 1999.

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18 Has New Zealand financial reporting regulation moved away from a self-regulatory model dominated by the accounting profession towards a government-regulated model? Explain your answer, providing arguments to support your view.

19 Identify the types of entities that are, or are likely to be, required to prepare financial statements in accordance with international accounting standards (that is to say, their New Zealand equivalents) after 1 January 2007 (1 January 2005 for early adopters). For each type of reporting entity consider whether the benefits of convergence with international accounting standards are likely to materialise.

20 The following newspaper article by Keith Alfredson, former chairperson of the AASB, called 'Simple solution for standard problem' and reproduced in Financial Accounting in the News 1.7, makes a number of criticisms of the FRC's decision to require Australia to adopt IFRSs. Identify Mr Alfredson's arguments and evaluate their respective merits.

1.7 FINANCIAL ACCOUNTING IN THE NEWS

SIMPLE SOLUTION FOR STANDARD PROBLEM

So a large number of Australian boards and chief financial officers are unprepared for the adoption of the new International Accounting Standards in 2005 ('Boards ignore new standards', *AFR*, October 30). This is hardly surprising since only one new standard is available.

Many boards would undoubtedly prefer and are waiting to deal with actual standards, rather than speculation from exposure drafts and subsequent tentative decisions of the IASB.

Given the now tight timetable to 2005, surely it is time for the Financial Reporting Council, the AASB and the government to re-consider the process for adopting international standards in Australia, for when the FRC set the strategy in June 2002 for their adoption from 2005, it was akin to signing a blank cheque—none of the significant details relating to new or revised standards were available. Indeed the same is still the case, though the eventual likely details are becoming clearer.

There is a simple solution. The AASB should exert its authority and resolve to retain the 2005 timetable for the adoption of international standards, but without the requirement to retrospectively restate the comparative report (in the case of a December balance date, the report for the year starting 1 January 2004).

Rather it should require entities to report the estimated impact of the change to international standards in the financial report in their first year of adoption (for a December balance, on the report for the year commencing 1 January 2005).

This would be consistent with past practice in Australia, which has never required the restatement of comparative financial reports when new standards have been adopted.

I challenge anyone to prepare a cost/benefit analysis that will support that it is imperative that the 2004 accounts of Australian entities (2004/2005 in the case of a 30 June balance) be restated.

I have no doubt that restatement is not essential for a 'true and fair view'.

The accounts for the financial year commencing on or after 1 January 2005 could be stated to be compliant with international standards, except for the non-restatement of the comparative accounts. The report for the next year would of course be fully compliant.

In any case, the IASB has tentatively decided that the comparative accounts need not be restated for the impacts of adopting IAS 32 and 39 (disclosure and recognition and measurement of financial instruments). As these standards are likely to cause considerable change to Australian financial reporting, especially for companies involved in hedging, securitisation and other financial engineering, the likely mandated restated comparative accounts are going to be somewhat 'half-baked' and not a true reflection of the full adoption of international standards.

This in itself gives ample justification for the adoption of my recommended approach.

Source:
Keith Alfredson, 'Simple solution for standard problem', *The Australian Financial Review*, 7 November 2003, p. 79.

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