# Financial reporting update

Government Departments/Crown Entities Client Update, March 2017

AUDIT NEW ZEALAND
Mana Arotake Aotearoa

# Agenda

- Improving communication in financial reports
- Accounting standard changes update
- Earthquake accounting matters

# Improving communication in financial reports

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# Objectives of financial reports

PBE Conceptual framework:

- Objectives of financial reporting
  - To provide information useful to users for accountability and decision-making
- Primary users
  - service recipients and their representatives and resource providers and their representatives

# Concerns about clarity of communication

- Volume of disclosure
- Too much immaterial disclosure
- Complexity and understandability of disclosure
- Duplication of information in notes and accounting policies
- Not enough information on key areas of judgement, or estimation
- Poor communication of key information

# Standard setters' response

IASB disclosure initiative projects:

- IAS 1 amendments (aggregation and sub-totals, materiality, accounting policies, order of notes)
- Materiality practice statement and clarified materiality definition
- Principles of disclosure (discussion paper due April 2017)
- Standards level disclosure review

NZ ASB

- Extension of IAS 1 **amendments to PBE IPSAS 1 (applies now)**
- Explanatory Guide: Materiality for Public Benefit Entities

# Definitions of materiality

- Information is material if its omission or misstatement could influence **the discharge of accountability** by the entity, or the **decisions that users make** on the basis of the entity's GPFRs prepared for that reporting period. Materiality depends on both the nature and amount of the item judged in the particular circumstances of each entity.
(PBE conceptual framework)

- Information is material if omitting, misstating or **obscuring** it could reasonably be expected to **influence decisions** primary users of general purpose financial statements make on the basis of financial information about a specific reporting entity.

  (IASB Definition of materiality project)

# Evolving good practice

- Accounting policies
  - Integration with notes
  - Considering understandability
  - Which policies are significant?
- Indexes, headings, graphics, colour
- Improving and expanding important disclosures
  - Judgements, estimates, assumptions, sensitivities
- Reducing and removing immaterial disclosures
- Considering order of notes
- Significant matters, exec summary or  or key developments note

# Good examples in NZ public sector

- Meridian Energy Ltd
- Air New Zealand
- Christchurch City Holdings Ltd
- Financial Markets Authority
- New Zealand Fire Service Commission

# Audit NZ response

- Acceptance of new approaches
- Model financial statements
- Expect Audit teams to engage on improving financial reporting

# Putting it into practice

- Treat as a project
- Senior management support
- Big Bang or incremental change
- Consider user needs
- Engage with stakeholders
    - Audit committee
- Engage with auditors early
    - Agree changes on pro-formas

# Concluding comments

- Focus on user needs and accountability
- Shift from compliance to communication
- Transparency remains key
- Unfortunately, complex transactions are likely to require complex disclosures
- Not a focus on reducing information, but on providing better quality and more relevant information

# Standards update

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# Standards update

- What’s new for 30 June 2017?
- Some future changes of interest

# New or amended PBE standards for 30 June 2017

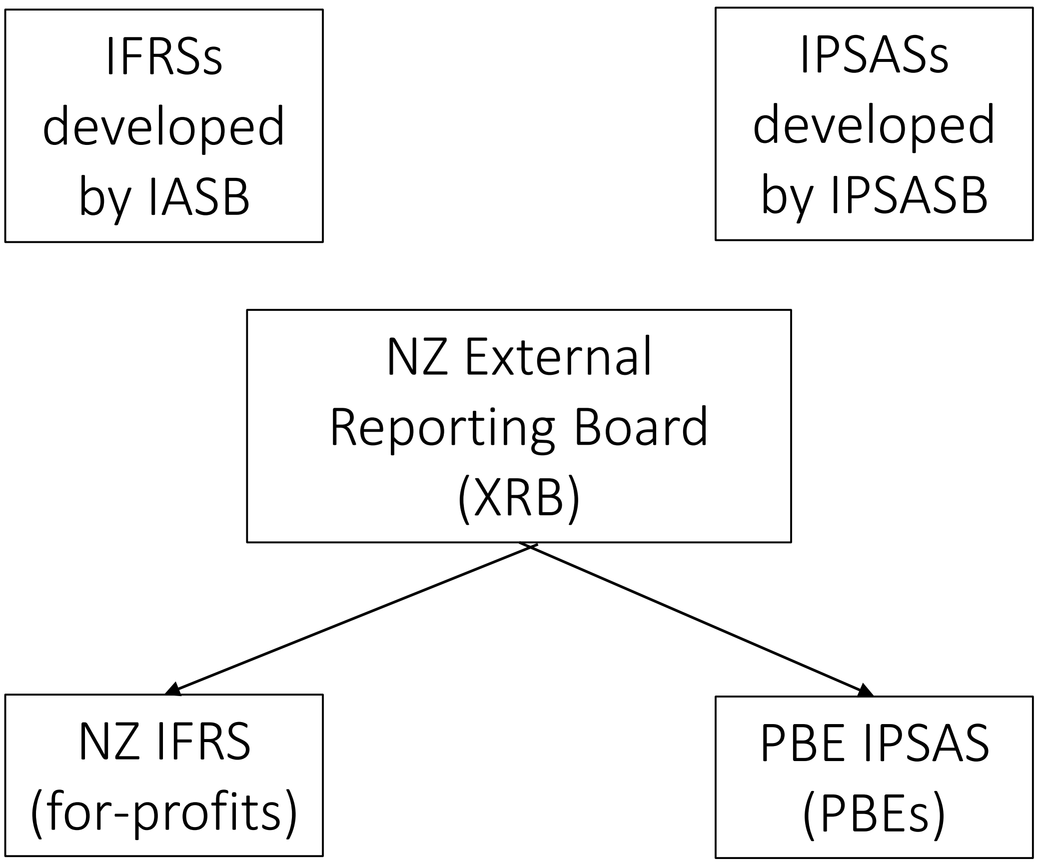
- No new PBE standards come into effect for 30 June 2017
- A number of standards have been amended e.g:

| Amended | Effective date | Description of change |
|---|---|---|
| PBE IPSAS 1 | 1 Jan 2016 | Disclosure initiative – as discussed earlier. |
| PBE IPSAS 17 | 1 Jan 2016 | Clarifies the treatment of the carrying amount and accumulated depreciation when an item of property, plant and equipment is revalued. |
| PBE IPSAS 20 | 1 Jan 2016 | Clarifies that an entity providing KMP services to the reporting entity or to the parent of the reporting entity (management entity) is a related party of the reporting entity. Requires disclosure of the amounts paid or payable to the management entity for the provision of key management personnel services. |
| PBE IPSAS 23 | 1 Jan 2016 | Permits an entity not to recognise donated goods that meet the definition of inventories if it is not practicable to measure reliably the fair value of those goods at the date of acquisition. |

# Amended PBE standards for 30 June 2018

| Amended | Effective date | Description of change |
|---|---|---|
| PBE IPSAS 12 | 1 Jan 2017 | Replaces the term “ammunition” with “military inventories” and includes a description of military inventories. |
| PBE IPSAS 17 | 1 Jan 2017 | Changes the scope of PBE IPSAS 17 to include biological assets that meet the definition of bearer plants (e.g., fruit trees).<br>Replaces the term “specialist military equipment” with “weapon systems” and includes a description of weapons systems. Clarifies some missiles may be PPE. |
| PBE IPSAS 32 | 1 Jan 2017 | Clarifies that service concession assets should be grouped with similar assets as a class of assets for the purpose of subsequent measurement, consistently with PBE IPSAS 17, and that dissimilar service concession assets cannot be accounted for as a class of assets. |

# Future changes that could be significant – Context of standards



# Future changes that could be significant - PBE IFRS 9 *Financial Instruments*

- For-profits must apply a new financial instruments (FI) standard, NZ IFRS 9, from 31 December 2018 year ends
- Potential for significant "mixed group" issues when for-profits and PBEs apply different FI standards
- PBE IFRS 9 is a new FI standard for PBEs, based on NZ IFRS 9,
- Mandatory effective date of 30 June 2021 , this provides PBEs with flexibility to early adopt to minimise mixed group issues
- New:
    - Classification requirements for financial assets
    - Impairment model
    - Hedge accounting requirements

# Future changes that could be significant - PBE IFRS 9 *Financial Instruments*

Some key implications:

- Share investments not held for trading can be designated at fair value through other comprehensive revenue and expense (FVTOCRE).
  - If designated at FVTOCRE, all fair value movements go through reserves, including impairment, and no realisation of gains or losses on disposal.
- Loans and receivables can only be measured at amortised cost if held with objective to collect contractual cash flows that are solely payments of principal and interest.
  - Unclear whether concessionary loans with contingent repayment features qualify for amortised cost accounting. If not, measured at fair value with movements in surplus/deficit.
    - Market-based discount rates required at balance date.
    - Expected losses included in estimating fair value.
    - Financial performance volatility.

# Future changes that could be significant - PBE IFRS 9 *Financial Instruments*

- Impairment of loans and receivables at amortised cost is now based on an “expected loss model”; previously unimpaired assets could now require impairment provisions
    - More complex
    - How significant could adjustments be?
    - Systems and processes to estimate these?
- Financial Statements of Government early adoption?

# Future changes that could be significant – Leases

- For-profits must apply a new lease standard, NZ IFRS 16, from 31 December 2019 year ends
- NZ IFRS 16 requires lessees to recognise most leases on the balance sheet
  - Lessor accounting largely unchanged from NZ IAS 17 *Leases*
- No NZ IFRS 16 PBE equivalent under development in NZ, but..
  - IPSASB is developing an exposure draft on leases:
    - Looking likely to bring lessees leases on balance sheet
    - Project is also considering “concessionary leases”
      - For example, peppercorn or nominal rental payments

# Future changes that could be significant – Revenue and non-exchange expenses

- For-profits must apply a new revenue standard, NZ IFRS 15, from 31 December 2018 year ends
- No IFRS 15 PBE equivalent under development in NZ, but…
  - IPSASB is developing a consultation paper on:
    - Revenue accounting by PBEs
    - Accounting for non-exchange expense, for example, grants
- We encourage entities that could be significantly affected to consider and comment on the consultation document when available

# Earthquake matters

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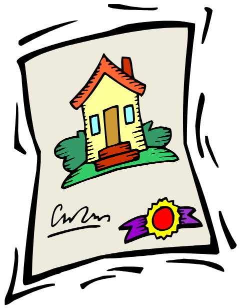
# Financial reporting considerations

- Insurance proceeds
- Damage to assets
- Lease payments for buildings not used
- Disclosures

**Significant judgement may need to be exercised**
**Who should exercise that judgement?**
**What evidence is available to support the judgement?**

# Insurance proceeds

- Insurance recoveries recognised when become **receivable**:
  - Applies to both property damage related and business interruption (BI) insurance
  - When insurer accepts claim and quantified
  - When insurer accepts claim and not quantified – best estimate
  - If a claim not yet accepted or impending claim not yet submitted, only recognise if acceptance of claim is "virtually certain" and asset can be reliably measured
  - If BI insurance is only re-imbursing as costs are incurred, revenue is recognised as those costs are incurred (subject to receipt being virtually certain)
  - Contingent asset disclosure where receipt is probable



- Presented gross in the surplus/deficit
- Potential for accounting mismatches and surplus/deficit volatility

# Damage to assets

- Assess if damaged asset is impaired or should be written-off:
  - An asset is written-off if it is expected it will provide no future use
    - Full carrying value derecognised to surplus/deficit as an expense
  - An asset is impaired if its use has been negatively affected and it is expected the asset is repairable/can be used again in future
    - Impairment test to be performed to determine extent of the reduction in the asset's value
    - For PBEs, PBE IPSAS 21 *Impairment of Non-Cash Generating Assets* discusses approaches to measuring impairment, such as the restoration cost approach and service units method

# Damage to assets

- If earthquake damage to an asset is minor and its use is essentially unaffected, the asset may not be impaired so no impairment test is necessary
- Judgement may be necessary when it is uncertain whether :
  - an entity would be able to reoccupy leased premises
  - an owned building is repairable

# Lease payments for buildings not used

- A liability (an onerous contract provision) for future lease payments may need to be recognised where an entity is making lease payments for unoccupied buildings
- The liability would be measured by estimating the future lease payments for which the building will be unoccupied
- Other matters to consider in measuring the liability:
  - Is there a force majeure provision to avoid the future lease payments? What legal advice has been obtained?
  - How long will the building remain unoccupied?

# Disclosures

- Some disclosure requirements to consider:
  - Disclosure of major budget variances,
  - Disclosure of significant accounting estimates and judgements
  - Disclose the amount of compensation recognised
  - Impairment related disclosures
  - Information about provisions, contingent liabilities and contingent assets
- For entities significantly affected, the best approach may be to provide all disclosures in an “earthquake” note
  - For example, refer to note 24 of University of Canterbury 2011 Annual Report (available on UoC’s website)

# Appropriation issues

- No offsetting of insurance recoveries
- Appropriation to be sought for earthquake damage expenses, such as asset impairments and write-offs
  - An “Other expense” appropriation
- For other earthquake related costs, entities need to carefully consider whether such costs be charged to an “output expense” or “other expense” appropriation.
- Engage with both Treasury and your auditor on appropriation issues

# Questions