



WHAT IS HEDGE ACCOUNTING? ... WHY EXPORTERS MIGHT CHOOSE TO APPLY HEDGE ACCOUNTING

The new financial instruments standard, NZ IFRS 9 *Financial Instruments*, significantly changes the rules for applying hedge accounting. These revised rules make hedge accounting far more achievable than is the case under the current rules.

In this article we look at:

- ▶ What is hedge accounting
- ▶ Why do entities that are exporters want to apply hedge accounting
- ▶ How effectiveness testing is much simpler under NZ IFRS 9.

What is hedge accounting and why do importers want to apply hedge accounting?

The basic premise of NZ IAS 39 *Financial Instruments: Recognition and Measurement* and NZ IFRS 9 *Financial Instruments* is that all derivatives must be recorded at fair value at each reporting date.

Where an exporter sells inventories priced in foreign currencies (e.g. USD selling price for dairy) and takes out a forward contract to lock in the foreign currency selling price, **if it does not apply hedge accounting:**

- ▶ The movement in the fair value of the derivative is recognised immediately in profit or loss
- ▶ On export, the sales price is recorded at the spot rate for the sales designated in foreign currencies.

If the exporter **does apply hedge accounting:**

- ▶ The movement in the fair value of the derivative is recognised in other comprehensive income (OCI) until the derivative is settled
- ▶ On export of the product, the selling price is recorded at the spot rate for the sales designated in foreign currencies but the balance in other comprehensive income is recognised as part of sales, which means that the selling price is recorded at the rate locked in by the forward contract

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Example**1 October 2014**

Entity B is an exporter of goods and its functional currency is the New Zealand dollar (NZD). It enters into a contract to supply 100,000 widgets for USD 100,000. The goods are to be delivered in six months' time. USD 100,000 is payable on delivery.

Entity B does not wish to be exposed to changes in the USD exchange rate. On 1 October 2014, it takes out a forward contract to sell USD 100,000 in six months' time at a rate of USD 0.75/NZD 1.

Note: Economic risk management aims to lock in the sales price for the widgets at NZD 133,333 (USD 100,000/0.75).

31 December 2014

The forward rate is USD 0.70/NZD 1.

The derivative is now a liability worth NZD 9,524 ((USD 100,000/0.75) – (USD 100,000/0.70)), representing the loss the holder of the derivative will make by selling US dollars at USD 0.75/NZD 1 compared with a market price forward price USD 0.70/NZD 1.

Fair value movement of the derivative from 1 October 2014 to 31 December 2014 is NZD 9,524 ((USD 100,000/0.75) – (USD 100,000/0.70)).

For simplicity, we have ignored the effect of time value of money and any credit/debit value adjustments.

No hedge accounting:

The journal entry if hedge accounting is not applied is as follows:

	DR	CR
DR Profit of loss	NZD 9,524	
CR Derivative liability		NZD 9,524

This accounting does not follow Entity B's hedge objective of the transaction i.e. to lock in a sales price at USD 0.75/NZD 1. Instead, it gives rise to significant profit and loss volatility, bringing forward a notional derivative loss on 31 December 2014.

31 March 2015

If the USD/NZD exchange rate remains at USD 0.70/NZD 1 when the goods are delivered on 31 March 2015 then the journal entries will be (assuming cost of goods sold is NZD 50,000):

	DR	CR
DR Receivable	NZD 142,857	
CR Revenue (USD 100,000/0.70)		NZD 142,857

To recognise revenue and receivable at the at the USD/NZD spot rate at 31 March 2015

	DR	CR
DR Cost of goods sold	NZD 50,000	
CR Inventory		NZD 50,000

To derecognise inventory and recognise costs of goods sold of NZD 50,000

	DR	CR
DR Derivative liability	NZD 9,524	
CR Cash		NZD 9,524

To derecognise the derivative liability and cash payment when the derivative is settled

The impact on the statement of profit or loss and other comprehensive income when there is **no hedge accounting** is as follows:

	2014	2015
Sales	-	142,857
Gain/loss from derivatives	(9,524)	-
Cost of goods sold	-	(50,000)
Profit or loss	(9,524)	92,857

This obviously does not reflect the economic hedge objective which was to protect Entity B from price volatility on known sales. The amount of sales revenue recognised does not reflect the economic risk management to lock in the sales price at NZD 133,333 (USD 100,000/0.75).

Hedge accounting

In order to defer recognising the hedging loss until 2015, the entity would have to apply hedge accounting. While still following the basic requirement that all derivatives must be recorded at fair value at each reporting date, for 'cash flow' hedges, hedge accounting allows any gain or loss on the derivative to be deferred by making an entry into other comprehensive income (OCI).

31 December 2014

The journal entry on 31 December 2014 if hedge accounting is applied:

	DR	CR
DR Loss on forward contract – hedge reserve (OCI)	NZD 9,524	
CR Derivative liability		NZD 9,524

To recognise the derivative at fair value and the changes in OCI

31 March 2015

When the goods are delivered and cash is received on 31 March 2015, the journal entries are:

	DR	CR
DR Receivable	NZD 142,857	
CR Revenue (USD 100,000/0.70)		NZD 142,857

To recognise revenue and receivable at the at the USD/NZD spot rate at 31 March 2015

	DR	CR
DR Cost of goods sold	NZD 50,000	
CR Inventory		NZD 50,000

To derecognise inventory and recognise costs of goods sold of NZD 50,000

	DR	CR
DR Derivative liability	NZD 9,524	
CR Cash		NZD 9,524

To derecognise the derivative liability and cash payment when the derivative is settled

	DR	CR
DR Revenue	NZD 9,524	
CR Loss on forward contract – hedge reserve (OCI)		NZD 9,524

To reclassify the loss in OCI to revenue as the sales impact profit or loss

The impact on the statement of profit or loss and other comprehensive income when **hedge accounting is applied** is as follows:

	2014	2015
Sales	-	133,333
Gain/loss from derivatives	-	-
Cost of goods sold	-	(50,000)
Profit or loss		83,333
OCI	(9,524)	9,524

(Note: This example assumes all the hedge effectiveness criteria are met and the hedge is 100 per cent effective.)

When the hedging transaction is recorded, the hedging gain or loss is **reclassified from OCI** against that hedged item. This results in sales revenue being recorded of NZD 133,333, reflecting the aim of economic risk management which is to lock in the sales price at NZD 133,333.

Effectiveness testing under NZ IFRS 9

A very onerous requirement of the current NZ IAS 39 rules on achieving hedge accounting is the need to prove that the hedging relationship will fall within the 80-125 per cent highly effective corridor.

NZ IFRS 9 has significantly simplified the hedge effectiveness testing criteria and has removed the 80-125 per cent highly effective corridor, as well as the mandatory requirement to perform forward and backward looking mathematical effectiveness tests.

Under NZ IFRS 9, if derivatives are entered into for the same quantity,

timing and pricing index as the forecast sales or purchases (i.e. the 'critical terms match'), it may be sufficient to only carry out a forward looking qualitative test, without the need to perform any further mathematical calculations.

Example

Entity C has forecast sales of USD 1million in six months' time. It does not wish to be exposed to changes in the USD exchange rate so it enters into a foreign exchange forward contract to sell USD 1million in six months' time. Assume that credit risk is not expected to deteriorate significantly.

Effectiveness testing is satisfied by the critical terms match test. The critical terms of the hedged item, being the forecast sales, matches the critical terms of the derivative, i.e.:

- ▶ Same quantity – USD 1million
- ▶ Same underlying risk – USD/NZD exchange rate
- ▶ Timing match - settlement date of the contract matches the timing of the sales receipts in USD.

Effective date and early adoption

Although NZ IFRS 9 does not come into effect until 1 January 2018, it can be early adopted. NZ IFRS 9 is applicable to all Tier 1 and Tier 2 for-profit entities.

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

'DECLUTTERING' YOUR FINANCIAL STATEMENTS – EASY STARTING POINT - YOUR ACCOUNTING POLICIES

The International Accounting Standards Board's (IASB's) Disclosure Initiative is gaining momentum, with many large listed entities already taking the initiative to 'declutter' and streamline their financial statements.

Many smaller entities, however, may be putting off starting the process of 'decluttering' because the task seems too daunting. In this article we will demonstrate that there are a few simple, painless steps you can take to kick start the process.

Getting started with accounting policies

While we wait for an Exposure Draft of a Practice Statement Application of materiality to financial statements to be issued (hopefully before the end of 2015) the best place to start your decluttering and streamlining process is with the accounting policies. Questions to ask include:

- ▶ Are your accounting policies relevant?
- ▶ Is any information from the accounting policies repeated in disclosure under the notes?
- ▶ Should they be reordered and moved to somewhere less prominent than note 1?
- ▶ Should the accounting policies be relocated under the appropriate note?
- ▶ Are there particular accounting policies that should be re-emphasised so the user clearly understands the financial report?

Many entities have pages and pages of boiler plate accounting policies extracted from a convenient set of model financial statements. In a number of cases, these accounting policies are not relevant to understanding the financial report, making it difficult for users to make decisions because of an information overload. Such financial statements tell the user little about what the business really does and how items are accounted for.

Significant accounting policies, not a summary of accounting policies

Remember that the recent amendments to NZ IAS 1 *Presentation of Financial Statements* made as part of the Disclosure Initiative clarify that an entity must disclose its significant accounting policies. This means that not all accounting policies need to be included, only those relevant to an understanding of the financial statements.

How to streamline accounting policies

We suggest the best way to start is to take the complete list of accounting policies in last year's financial statements and strike through any superfluous policies.

This means being ruthless. If your entity does not regularly enter into a certain type of transaction, or does not, during the current or previous year, have a balance sheet item on your books, delete it.

Example

Background information relating to XYZ Limited is as follows:

- ▶ XYZ limited is a national retailer of its own brand of women's clothing. It has 50 stores spread throughout New Zealand.
- ▶ XYZ Limited is a Tier 1 for-profit entity.
- ▶ Growth is via organic growth only. The group policy is not to acquire other clothing brands or businesses. It has therefore made no acquisitions in the past five years.
- ▶ All of the Group's subsidiaries are 100 per cent owned. The Group has no interests in joint arrangements or associates.
- ▶ Fabrics are imported from Italy and payments are denominated in EURO. The entity takes out forward contracts to fix the price of fabric imports in New Zealand dollars but does not apply hedge accounting. All manufacturing is done in China.
- ▶ All stores occupy premises on operating leases. Funds for store fitout come from share capital raisings for store expansion.
- ▶ Head office occupies a building in the Wellington CBD that the entity has owned for 50 years. The building is not revalued because valuers charge too much money to conduct valuations.
- ▶ The group does not have any investments or long-term loans receivable.
- ▶ The group has bank borrowings (at fixed interest rates) but no preference shares or convertible notes.
- ▶ The group does not take out derivatives in respect of interest rates.

A selection of accounting policies disclosed in the 31 December 2014 financial statements is noted below. The yellow shaded areas are suggestions of information that could be deleted from XYZ Limited's accounting policies. You can see the difference that these deletions will make to the length of the overall accounting policies.

ACCOUNTING POLICY

Basis of consolidation

Subsidiaries

The consolidated financial statements comprise the financial statements of XYZ Limited and its subsidiaries at 31 December 2014 each year ("the group"). Subsidiaries are entities (including structured entities) over which the group has control. The group has control over an entity when the group is exposed to, or has rights to, variable returns from its involvement with the entity, and has the ability to use its power to affect those returns. Subsidiaries are consolidated from the date on which control is transferred to the group and are deconsolidated from the date that control ceases.

All intercompany balances and transactions, including unrealised profits arising from intragroup transactions have been eliminated. Unrealised losses are also eliminated unless the transaction provides evidence of the impairment of the asset transferred.

Non-controlling interests in the results and equity of subsidiaries are shown separately in the consolidated statement of profit or loss and other comprehensive income and statement of financial position respectively. Total comprehensive income is attributable to owners of XYZ Limited and non-controlling interests even if this results in the non-controlling interests having a debit balance.

Associates

Associates are entities over which the Group has significant influence but not control or joint control. Associates are accounted for in the parent entity financial statements at cost and the consolidated financial statements using the equity method of accounting. Under the equity method of accounting, the group's share of post-acquisition profits or losses of associates is recognised in consolidated profit or loss and the group's share of post-acquisition other comprehensive income of associates is recognised in consolidated other comprehensive income. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. Dividends received from associates are recognised in the parent entity's profit or loss, while they reduce the carrying amount of the investment in the consolidated financial statements.

When the Group's share of post-acquisition losses in an associate exceeds its interest in the associate (including any unsecured long-term receivables), the Group does not recognise further losses unless it has obligations to, or has made payments, on behalf of the associate.

The financial statements of the associates are used to apply the equity method. The end of the reporting period of the associates and the parent are identical and both use consistent accounting policies.

Joint arrangements

Joint arrangements are arrangements in which one or more parties have joint control (the contractual sharing of control of an arrangement where decisions about relevant activities require unanimous consent of the parties sharing control).

Joint operations

XYZ Limited has entered into joint arrangements which are classified as joint operations because the parties to the joint arrangements have rights to the assets and obligations for the liabilities, rather than to the net assets, of the joint arrangements. XYZ Limited has recognised its direct right to, as well as its share of jointly held, assets, liabilities, revenues and expenses of joint operations which have been included in the financial statements under the appropriate headings.

Details of joint operations are set out in Note 5.

Joint ventures

Interests in joint ventures are accounted for in the consolidated financial statements using the equity method and in the parent entity financial statements at cost. Under the equity method of accounting, the group's share of profits or losses of joint ventures are recognised in consolidated profit or loss and the group's share of the movements in other comprehensive income of joint ventures are recognised in consolidated other comprehensive income. The cumulative movements are adjusted against the carrying amount of the investment.

ACCOUNTING POLICY

Details of joint ventures are set out in Note 6.

When the group's share of post-acquisition losses in a joint venture exceeds its interest in the joint venture (including any long term interests that form part of the group's net investment in the joint venture), the group does not recognise further losses unless it has obligations to, or has made payments, on behalf of the associate.

Changes in ownership interests

Transactions with non-controlling interests that increase or decrease the group's ownership interest in a subsidiary, but which do not result in a change of control, are accounted for as transactions with equity owners of the group. An adjustment is made between the carrying amount of the group's controlling interest and the carrying amount of the non-controlling interests to reflect their relative values in the subsidiary. Any difference between the amount of the adjustment to the non-controlling interest and any consideration paid or received is recognised in a separate reserve within equity attributable to owners of XYZ Limited.

Where the group loses control of a subsidiary but retains significant influence, joint control, or an available-for-sale investment, the retained interest is remeasured to fair value at the date that control is lost, and the difference between fair value and the carrying amount is recognised in profit or loss. This fair value is the initial carrying amount for the retained investment in associate, joint venture or available-for-sale financial asset. If no ownership interest is retained, or if any remaining investment is classified as available-for-sale, any amounts previously recognised in other comprehensive income in respect of the entity are accounted for as if the group had directly disposed of the related assets or liabilities and may be recognised in profit or loss. To the extent that the group retains significant influence or joint control, balances of other comprehensive income relating to the associate or joint venture entity will only be reclassified from other comprehensive income to profit or loss to the extent of the reduced ownership interest so that the balance of other comprehensive represents the group's proportionate share of other comprehensive income of the associate/joint venture.

If the group's ownership interest in an associate or a joint venture is reduced, but the group retains significant influence or control, only a proportionate share of the amounts previously recognised in other comprehensive income are reclassified to profit or loss, where appropriate

BDO COMMENTS:

- As all subsidiaries are wholly-owned, there is no need for an accounting policy about non-controlling interests
- As there are no associates or joint arrangements, there is no need for accounting policies on associates, joint arrangements, joint operations or joint ventures
- Consider including an explicit cross reference to the list of material subsidiaries.

Business combinations

The acquisition method of accounting is used to account for all business combinations. Consideration is measured at the fair value of the assets transferred, liabilities incurred, and equity interests issued by the group on acquisition date. Consideration also includes the acquisition date fair values of any contingent consideration arrangements, any pre-existing equity interests in the acquiree and share-based payment awards of the acquiree are required to be replaced in a business combination. The acquisition date is the date on which the group obtains control of the acquiree. Where equity instruments are issued as part of the consideration, the value of the equity instruments is their published market price at the acquisition date unless, in rare circumstances it can be demonstrated that the published price at acquisition date is not fair value and that other evidence and valuation methods provide a more reliable measure of fair value.

Identifiable assets acquired and liabilities and contingent liabilities assumed in business combinations are, with limited exceptions, initially measured at their fair values at acquisition date. Goodwill represents the excess of the consideration transferred and the amount of the non-controlling interest in the acquiree over fair value of the identifiable net assets acquired. If the consideration and non-controlling interest of the acquiree is less than the fair value of the net identifiable assets acquired, the difference is recognised in profit or loss as a bargain purchase price, but only after a reassessment of the identification and measurement of the net assets acquired.

For each business combination, the group measures non-controlling interests at either fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.

Acquisition-related costs are expensed when incurred. Transaction costs arising on the issue of equity instruments are recognised directly in equity and transaction costs arising on the issue of debt as part of the consideration are accounted for in accordance with note 1(u).

Where the group obtains control of a subsidiary that was previously accounted for as an equity accounted investment in associate or joint venture, the group remeasures its previously held equity interest in the acquiree at its acquisition date fair value and the resulting gain or loss is recognised in profit or loss. Where the group obtains control of a subsidiary that was previously accounted for as an available-for-sale investment, any balance on the available-for-sale reserve related to that investment is recognised in profit or loss as if the group had disposed directly of the previously held interest.

Where settlement of any part of the cash consideration is deferred, the amounts payable in future are discounted to present value at the date of exchange using the entity's incremental borrowing rate as the discount rate.

Contingent consideration is classified as equity or financial liabilities. Amounts classified as financial liabilities are subsequently remeasured to fair value at the end of each reporting period, with changes in fair value recognised in profit or loss.

Assets and liabilities from business combinations involving entities or businesses under common control are accounted for at the carrying amounts recognised in the group's controlling shareholder's consolidated financial statements.

BDO COMMENTS:

- As the group has not undertaken any business combinations, there is no need for an accounting policy about business combinations

ACCOUNTING POLICY

The Group uses derivative financial instruments such as forward foreign currency contracts and interest rate swaps to hedge its risk associated with interest rate and foreign currency fluctuations. Such derivatives are stated at fair value. The fair value of forward exchange contracts is calculated by reference to current forward exchange rates for contracts with similar maturity profiles. The fair value of interest rate swap contracts is determined by reference to market values for similar instruments.

For derivatives that do not qualify for hedge accounting, any gains or losses arising from changes in fair value are taken directly to net profit or loss for the year.

For derivatives that qualify for hedge accounting, the method for recognising gains and losses on changes in fair value depends on whether the derivative is classified as a fair value hedge or a cash flow hedge. Derivatives are classified as fair value hedges when they hedge the exposure to changes in the fair value of a recognised asset or liability and as cash flow hedges when they hedge exposure to variability in cash flows that are attributable to either a particular risk associated with a recognised asset or liability or to a forecast transaction. The Group documents at inception of the hedge the relationship between the hedging instruments (derivatives) and the hedged items, as well as the risk management objective and strategy for undertaking the hedge transaction. The Group also documents, both at inception of the hedge and on an ongoing basis whether the derivatives that are used in the hedging transactions have been, and will continue to be, highly effective in offsetting changes in fair values or cash flows of hedged items.

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in profit or loss, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. The gain or loss relating to the effective portion of interest rate swaps hedging fixed rate borrowings is recognised in profit or loss within finance costs together with changes in the fair value of the hedged fixed rate borrowings attributable to interest rate risk. The gain or loss relating to the ineffective portion is recognised in profit or loss within other income or other expenses.

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income in the hedging reserve and reclassified to profit or loss when the hedged item affects profit or loss. The gain or loss relating to the ineffective portion is recognised immediately in profit or loss.

Amounts accumulated in other comprehensive income are recognised in profit or loss as a reclassification adjustment in periods when the hedged item affects profit or loss (e.g. when the forecast sale takes place). The gain or loss relating to the effective portion of interest rate swaps hedging variable rate borrowings is recognised in profit or loss as finance costs. The gain or loss on the effective portion of forward exchange contracts hedging export sales is recognised in profit or loss within sales. However, when the cash flow hedge relates to a forward foreign exchange contract to hedge a highly probable forecast transaction or firm commitment that results in a non-financial asset (e.g. inventory or fixed assets), the gains and losses previously deferred in other comprehensive income are reclassified and included in the initial measurement of the cost of the asset. The deferred amounts are ultimately recognised in profit or loss as costs of goods sold in the case of inventory, or as depreciation in the case of fixed assets.

Hedge accounting is discontinued when the hedging instrument expires, or is sold, terminated or exercised, or no longer qualifies for hedge accounting. At that point in time any cumulative gains or losses on the hedging instrument recognised in other comprehensive income is kept in other comprehensive income until the forecast transaction occurs. If the forecast transaction is no longer expected to occur, the cumulative gain or loss recognised in other comprehensive income is recognised in profit or loss for the year as a reclassification adjustment.

BDO COMMENTS:

- As the group does not apply hedge accounting, there is no need for an accounting policy on hedge accounting
- As the group has not entered into any interest rate swaps, references to interest rate swaps can be deleted.

Property, Plant and Equipment

Land and buildings are measured at fair value less accumulated depreciation. Any accumulated depreciation at revaluation date is eliminated against the gross carrying amount of the asset and the net amount is restated as the revalued amount of the asset. A revaluation surplus is credited to other comprehensive income (asset revaluation surplus) unless it reverses a revaluation decrease on the same asset previously recognised in profit or loss. A revaluation deficit is recognised in profit or loss unless it directly offsets a previous revaluation surplus on the same asset in the asset revaluation surplus. An annual transfer is made from the asset revaluation surplus to retained earnings for the depreciation charge recognised in profit or loss (net of tax) relating to the revaluation surplus. On disposal, any revaluation surplus relating to sold assets is transferred to retained earnings. Independent valuations are performed regularly to ensure that the carrying amounts of land and buildings does not differ materially from that the fair value at the end of the reporting period.

Land and buildings and other plant and equipment is stated at historical cost, including costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, less depreciation and any impairments.

Land is not depreciated. Depreciation on other assets is calculated on a straight-line basis over the estimated useful life, or in the case of leasehold improvements and certain leased plant and equipment, the shorter lease term, as follows:

• Buildings	40 years
• Machinery	10 - 15 years
• Vehicles	3 - 5 years
• Furniture, fittings and equipment	3 - 8 years

The assets' residual values and useful lives are reviewed and adjusted, if appropriate, at the end of each reporting period.

Gains and losses on disposals are calculated as the difference between the net disposal proceeds and the asset's carrying amount and are included in profit or loss in the year that the item is derecognised.

Spare parts, stand-by equipment and servicing equipment are classified as property, plant and equipment if they are expected to be used during more than one period. Otherwise they are classified as inventory

BDO COMMENTS:

- As the group does not apply revaluation accounting to land and buildings, the relevant paragraph should be deleted
- As all manufacturing is done in China, it is unlikely that the group would have material balances of spare parts, stand-by equipment etc. This policy should therefore be deleted.
- Consider placing this information in the PPE note

ACCOUNTING POLICY**Leases**

Leases of property, plant and equipment where the Group has substantially all the risks and rewards of ownership are classified as finance leases and capitalised at inception of the lease at the fair value of the leased property, or if lower, at the present value of the minimum lease payments. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged to profit or loss over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Capitalised leased assets are depreciated over the shorter of the estimated useful life of the asset or the lease term.

Leases where the lessor retains substantially all the risks and rewards of ownership of the net asset are classified as operating leases. Payments made under operating leases (net of incentives received from the lessor) are charged to profit or loss on a straight-line basis over the period of the lease.

When assets are leased out under finance leases, the present value of the lease payments is recognised as a lease receivable. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance income. Lease income is recognised over the lease term using the net investment method which reflects a constant periodic rate of return.

Lease income from operating leases is recognised in profit or loss on a straight-line basis over the lease term. Initial direct costs incurred in negotiating operating leases are added to the carrying value of the leased asset and recognised as an expense over the lease term on the same bases as the lease income.

BDO comments:

- All policies relating to finance leases can be deleted as the group only has operating leases for the 50 stores.

Investments and other financial assets

All investments and other financial assets are initially stated at cost, being the fair value of consideration given plus acquisition costs. Purchases and sales of investments are recognised on trade date which is the date on which the Group commits to purchase or sell the asset. Accounting policies for each category of investments and other financial assets subsequent to initial recognition are set out below.

Held for Trading

Investments held for trading are measured at fair value with gains or losses recognised in profit or loss. A financial asset is classified as held-for-trading if acquired principally for the purpose of selling in the short term or if it is a derivative that is not designated as a hedge. Assets in this category are classified as current assets in the statement of financial position if they are expected to be settled within 12 months; otherwise they are classified as non-current assets.

Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group has the positive intention and ability to hold-to-maturity and are measured at amortised cost subsequent to initial recognition using the effective interest method. If the Group were to sell other than an insignificant amount of held-to-maturity investments, the whole category is then reclassified as available-for-sale.

Available-for-sale financial assets

Available-for-sale financial assets comprise investments in listed and unlisted entities and any non-derivatives that are not classified as any other category of financial assets, and are classified as non-current assets (unless management intends to dispose of the investment within 12 months of the end of the reporting period). After initial recognition, these investments are measured at fair value with gains or losses recognised in other comprehensive income (available-for-sale investments reserve). Where there is a significant or prolonged decline in the fair value of an available-for-sale financial asset (which constitutes objective evidence of impairment) the full amount including any amount previously charged to other comprehensive income is recognised in profit or loss. Purchases and sales of available-for-sale financial assets are recognised on settlement date with any change in fair value between trade date and settlement date being recognised in other comprehensive income. On sale, the amount held in available-for-sale reserves associated with that asset is recognised in profit or loss as a reclassification adjustment.

Interest on corporate bonds classified as available-for-sale is calculated using the effective interest rate method and is recognised in finance income in profit or loss.

Investments in subsidiaries, associates and joint ventures are accounted for in the consolidated financial statements as described in note 1(b) and in the parent entity financial statements at cost in accordance with the cost alternative permitted in separate financial statements under NZ IAS 27 *Separate Financial Statements*.

Reversals of impairment losses on equity instruments classified as available-for-sale cannot be reversed through profit or loss. Reversals of impairment losses on debt instruments classified as available-for-sale can be reversed through profit or loss where the reversal relates to an increase in the fair value of the debt instrument occurring after the impairment loss was recognised in profit or loss.

The fair value of quoted investments are determined by reference to NZX quoted market bid prices at the close of business at the end of the reporting period. For investments where there is no quoted market price, fair value is determined by reference to the current market value of another instrument which is substantially the same or is calculated based on the expected cash flows of the underlying net asset base of the investment.

Loans and receivables

Non-current loans and receivables include loans due from related parties repayable within 366 days of the end of the reporting period. As these are non-interest bearing, fair value at initial recognition requires an adjustment to discount these loans using a market-rate of interest for a similar instrument with a similar credit rating. The discount is debited on initial recognition to the investment in subsidiary.

Impairment losses are measured as the difference between the investment's carrying amount and the present value of the estimated future cash flows, excluding future credit losses that have not been incurred. The cash flows are discounted at the investment's original effective interest rate. Impairment losses are recognised in profit or loss.

BDO COMMENTS:

- Most of this policy can be deleted as the group does not have any investments or non-current loans receivable
- As the entity is simply complying with NZ IAS 39 *Financial Instruments: Recognition and Measurement*, consider whether this accounting policy is required. Does it add any value to the understanding of the financial report because the financial report explicitly states that it complies with NZ IFRS?

ACCOUNTING POLICY**Borrowings**

All loans and borrowings are initially recognised at fair value, net of transaction costs incurred. Borrowings are subsequently measured at amortised cost. Any difference between the proceeds (net of transaction costs) and the redemption amount is recognised in profit or loss over the period of the loans and borrowings using the effective interest method. Fees paid for establishing loan facilities are recognised as transaction costs if it is probable that some or all of the facility will be drawn down, and deferred until the draw down occurs. If it is not probable that the facility will be drawn down, fees are capitalised as prepayments for liquidity services and amortised over the period to which the facility relates.

Borrowings are derecognised from the statement of financial position when the obligation specified in the contract has been discharged, cancelled or expires. The difference between the carrying amount of the borrowing derecognised and the consideration paid is recognised in profit or loss as other income or finance costs.

Where the terms of a borrowing are renegotiated and the group issues equity instruments to a creditor to extinguish all or part of a borrowing, the equity instruments issued as part of the debt for equity swap are measured at the fair value of the equity instruments issued, unless the fair value cannot be measured reliably, in which case, they are measured at the fair value of the debt extinguished. The difference between the carrying amount of the debt extinguished and the fair value of the equity instruments issued is recognised as a gain or loss in profit or loss.

Preference shares which are mandatorily redeemable on a specific date are classified as liabilities. The dividends on these preference shares are recognised in profit or loss as interest expense.

The fair value of a liability portion of a convertible note is determined using a market rate of interest for an equivalent non-convertible note and stated on an amortised cost basis until conversion or maturity of the notes. The remainder of the proceeds is allocated to the conversion option and is shown as equity. Issue costs are apportioned between the liability and equity components based on the allocation of proceeds to the liability and equity components when the instruments are first recognised.

BDO COMMENTS:

- There are no preference shares or convertible notes so these policies should be deleted
- If there are no changes to terms of borrowings (derecognition or renegotiation), these policies should also be deleted
- As the entity is simply complying with NZ IAS 39, consider whether this accounting policy is required. Does it add any value to the understanding of the financial report because the financial report explicitly states that it complies with NZ IFRS?

Fair Values

Fair values may be used for financial asset and liability measurement and well as for sundry disclosures.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It is based on the presumption that the transaction takes place either in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market. The principal or most advantageous market must be accessible to, or by, the group.

Fair value is measured using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their best economic interest.

The fair value measurement of a non-financial asset takes into account the market participant's ability to generate economic benefits by using the asset at its highest and best use or by selling it to another market participant that would use the asset at its highest and best use.

In measuring fair value, the group uses valuation techniques that maximise the use of observable inputs and minimise the use of unobservable inputs.

BDO COMMENTS:

- No assets or liabilities are measured in the financial statements at fair value. Therefore fair value policy only needs to refer to sundry disclosures required about fair value in the financial statements
- Fair value only needs to be disclosed for the fixed rate borrowings, so reference to highest and best use of non-financial assets can be deleted.

Resources

Refer to our previous Accounting Alert articles in [May 2015](#) and [October 2015](#) for tips to get started with your decluttering and streamlining process.

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



CHANGING AUDIT REPORTS

The New Zealand Auditing and Assurance Standards Board has issued one new and six revised auditor reporting standards, plus conforming amendments to other International Standards on Auditing (New Zealand), designed to enhance auditors' reports for users of financial statements. The new and revised standards will be effective for audits of financial statements for periods ending on or after 15 December 2016. Early adoption is permitted.

The changes introduced by the new and amended standards will result in substantial changes to the look and feel of audit reports, particularly for listed issuers (and later for FMC reporting entities considered to have a higher level of public accountability).

The key changes include:

- ▶ The requirement to present the audit opinion at the beginning of the audit report
- ▶ An increased focus on going concern matters
- ▶ A new requirement to communicate key audit matters (this is initially only required for the audits of financial statements of listed issuers but, for periods ending on or after 31 December 2018 is also required for the audits of other FMC reporting entities considered to have a higher level of public accountability).

FMC reporting entities (other than listed issuers) that are considered to have a higher level of public accountability include:

- ▶ Equity issuers that make a regulated offer (and have more than 50 shareholders)
- ▶ Debt issuers that make a regulated offer
- ▶ Licensed derivative issuers
- ▶ Licensed Managed Investment Scheme (MIS managers) (in respect of the financial statements of the MIS they manage)
- ▶ Recipients of money from conduit issuers
- ▶ Registered banks
- ▶ Licensed insurers
- ▶ Credit unions
- ▶ Building societies.

Going concern

The primary changes in relation to going concern matters are:

- ▶ The provision of new guidance to support the auditor's evaluation of disclosures when a material uncertainty exists
- ▶ A new requirement for the auditor to evaluate the adequacy of disclosures in "close call" situations (situations where events or conditions were identified that may cast significant doubt on the entity's ability to continue as a going concern, but after considering management's plans to deal with these events or conditions, management and the auditor concluded that no material uncertainty exists)

- ▶ Where there are material uncertainties in relation to going concern, a requirement for the audit report to highlight the existence of those uncertainties and to include, if the disclosures are adequate, a separate section under the heading "Material Uncertainty Related to Going Concern" drawing attention to those disclosures, or, if the disclosures are inadequate, a modified opinion as the first section of the auditor's report
- ▶ A new requirement for the auditor's report to include descriptions of the responsibilities of the auditor and management in relation to going concern.

Key audit matters

Key audit matters are those matters that, in the auditor's judgement, were of most significance in the audit of the current-period financial statements. The audit report will need to identify the key audit matters and, for each identified key audit matter, provide a clear, concise, understandable and entity-specific description of the matter. That description will be required to state why the matter was considered to be one of most significance in the audit, explain how the matter was addressed in the audit and reference any related disclosures in the financial statements.

Preparing for the changes

The increased focus on going concern and the requirement, for some entities, to disclose key audit matters, will have an impact on the relationship between the entity being audited and its auditor. The most effective way to manage this impact is open and honest discussion on the likely impact of these changes on future audit reports. Many entities that will have information on key audit matters included in the audit report are already working with their auditor to examine what their future audit reports might look like.

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

DOES THE IDEA OF HAVING A TAX AUDIT WORRY YOU? IFRIC ED RELEASED ON UNCERTAIN TAX POSITIONS

WOULD YOU BE CONCERNED IF YOUR COMPANY WERE SUBJECT TO A TAX AUDIT, AND THE TAX AUTHORITY HAD FULL KNOWLEDGE OF ALL RELEVANT INFORMATION WHEN AUDITING YOUR COMPANY?

HAVE YOU QUANTIFIED THE IMPACT OF A FULL TAX AUDIT ON YOUR COMPANY, ASSUMING THE TAX AUTHORITIES KNOW ALL RELEVANT INFORMATION?

If you are a Tier 1 or Tier 2 for-profit entity and you are concerned about the results of your company being subject to a tax audit, undertaken by tax inspectors asking all of the correct questions, and holding all of the pertinent information, then you should definitely be concerned about the new Draft IFRIC Interpretation DI/2015/1 *Uncertainty over Income Tax Treatments*, which has been released.

The Interpretations Committee has determined that there is inconsistency as to how entities measure their current and deferred tax assets and liabilities, and unused tax losses, where there may be uncertainty as to how a tax authority would rule on a particular tax treatment if they:

- a. Were aware of the matter, and
- b. Had all the facts.

In some instances it would appear there is a practice of factoring in the probability of detection into measurement of tax balances.

Examination by taxation authorities

Draft Interpretation DI/2015/1, paragraph 13

'In assessing whether and how an uncertain tax treatment affects the determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates, an entity shall assume that a taxation authority with the right to examine amounts reported to it will examine those amounts and have full knowledge of all relevant information when making those examinations.'

The Draft Interpretation clearly states that the likelihood of detection should be excluded from the measurement of the tax balance. It does recognise that in some jurisdictions a statute of limitation exists in respect of tax authorities being able to reopen tax matters or conduct a tax audit. In these cases, entities may have to release tax provisions once the legal right to a tax audit has passed.

What if it is probable that the tax authority will accept the uncertain tax treatment?

The Draft Interpretation proposes that if it is probable that the tax authority will accept an uncertain tax position, no action is required, and tax balances are to be calculated consistently with the tax treatment used or planned to be used in the tax return.

What if it is not probable?

If it is not probable that the tax authority will accept the uncertain tax position, tax balance calculations will need to reflect this uncertainty, using one of the following methods:

- ▶ Most likely amount (single most likely amount in a range of possible outcomes), or
- ▶ Expected value (sum of the probability-weighted amounts in a range of possible outcomes).

The method used should be the one that provides a better prediction of the resolution of the uncertainty.

Responsibilities

The new clarified measurement rules will prove challenging for:

- ▶ Preparers
- ▶ Audit committee members
- ▶ Boards, and
- ▶ Auditors.

It is the responsibility of preparers and boards to ensure that their financial reports are compliant with accounting standards. An auditor must gather sufficient and appropriate audit evidence to support their opinion.

For many New Zealand Tier 1 and Tier 2 for-profit entities, this draft interpretation, should it be adopted, will require careful evaluation of any tax positions, where Inland Revenue may form a different opinion on the tax treatment adopted. It is likely to require key estimates and judgements to be disclosed in the notes to the financial statements. It would provide fertile ground for Inland Revenue to obtain information and is likely to be part of any risk review ahead of triggering a tax audit.

A sudden release of tax provisions once the statute bar period is past could also indicate a need for a tax audit.

Have your say

Comments on the Draft Interpretation close on 14 December 2015 to the New Zealand Accounting Standards Board. You can access the [Draft Interpretation here](#).

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



NEW BDO PUBLICATIONS

The **Audit** section of our website (www.bdo.co.nz/audit) includes a range of publications on accounting standards issues. For example:

- ▶ **NZ IFRS Industry Issues** contains a high level overview of the impact of new standards on particular industries. Recent NZ IFRS Industry Issues include overviews of the impact of NZ IFRS 15 *Revenue from Contracts with Customers* on the manufacturing; retail; telecommunications, software; media, construction-real estate and professional services industries.
- ▶ **Summaries on a Page (SOAPs)** contain summaries of NZ IFRS Standards for for-profit entities and PBE Standards for public sector and not-for profit entities currently in effect in New Zealand.

Also look for the '**BDO International IFRS**' link which includes resources such as:

- ▶ **IFRS at a glance** – 'one page' and short summaries of all IFRS standards.
- ▶ **IFRS News at a glance** – provides high-level headlines of newly released documents by the IASB and IFRS related announcements by securities regulators.
- ▶ **Need to Knows** – updates on major IASB projects and highlights practical implications of forthcoming changes to accounting standards. Recent Need to Knows include IFRS 9 *Financial Instruments – Classification and Measurement* (April 2015), IFRS 9 *Financial Instruments - Impairment of Financial Assets* (Dec 2014), IFRS 15 *Revenue from Contracts with Customers* (Aug 2014), IFRS 9 *Financial Instruments* (May 2014), *Hedge Accounting* (IFRS 9 *Financial Instruments*) (Jan 2014).
- ▶ **IFRS in Practice** – practical information about the application of key aspects of IFRS, including industry specific guidance. Recent IFRS in Practice include IFRS 15 *Revenue from Contracts with Customers – Transition*; IFRS 15 *Revenue from Contracts with Customers* (Oct 2014), IAS 7 *Statement of Cash Flows, Distinguishing between a business combination and an asset purchase in the extractives industry* (March 2014), IAS 36 *Impairment of Assets* (Dec 2013) and *Common Errors in Financial Statements – Share-based Payment* (Dec 2013).
- ▶ **Comment letters on IFRS standard setting** – includes BDO comments on various projects of international standard setters, including Exposure Drafts and other Discussion Papers, when it is considered that the issue is significant to the BDO network and its clients. Latest comment letters include IASB ED 2015-2 Effective Date of IFRS 15, ED IAS ED 2015-1 *Classification of Liabilities, Basel Committee on Banking Supervision – Guidance on accounting for expected credit losses*, IASB ED 2014-06 *Disclosure Initiative*, IASB - ED 2014-4 *Measuring Quoted Investments in Subsidiaries*, IASB - ED 2014-3 *Recognition of Deferred Tax Assets for Unrealised Losses*.

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

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