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ACCOUNTING FOR DONATED GOODS

Public benefit entities ("PBEs") are in the process of moving to the new suite of PBE accounting standards:

- Public sector PBEs are applying the new standards for financial reporting periods beginning on or after 1 July 2014 (i.e. for balance dates from 30 June 2015)
- Not-for-profit PBEs are applying the new standards for financial reporting periods beginning on or after 1 April 2015 (i.e. for balance dates from 31 March 2016).

One of the key differences that has been introduced by PBE accounting standards is the requirement to recognise so-called non-exchange transactions at their fair value, in accordance with the requirements of PBE IPSAS 23 *Revenue from Non-Exchange Transactions* ("PBE IPSAS 23"). Non-exchange transactions are transactions in which an entity either receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving approximately equal value in exchange. Examples of non-exchange transactions include taxes, bequests, donations and, in most circumstances, grants.

The requirement to recognise non-exchange transactions at fair value in accordance with PBE IPSAS 23 means that a not-for-profit that received donated goods would have to determine the fair value of those goods when they were received and recognise those goods at that fair value, with a corresponding entry to revenue. As outlined in the October 2014 *Assurance Alert*, for entities, such as charity shops, that receive a large number of low-value donated items, such as used clothing, books and toys, the requirement to measure those donated items in this manner would be onerous.

In most instances, the requirement to measure donated goods at fair value would also change the timing of revenue recognition. Currently, most charity shops do not recognise donated goods until they are sold, when the journal entry is:

Dr Cash (sale price)

Cr Revenue (sale price)

However, accounting for donated goods in the manner currently required by IPSAS 23 would result in two journal entries being made – one when the donated goods are received and the second when the donated goods are sold. The entry that would be made when the goods were received would be:

Dr Inventory (fair value of the item)

Cr Revenue (fair value of the item).

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The entry that would be made when the goods were sold would be:

Dr Cash (sale price)

Cr Revenue (sale price)

Dr Cost of goods sold (fair value of the item, unless the item had been written down to net realisable value)

Cr Inventory (fair value of the item, unless the item had been written down to net realisable value).

As inventory is required to be carried at the lower of cost (which in the case of donated items is fair value at the date of acquisition) and net realisable value, the value of inventory would also need to be assessed at each balance date and, if required, written down to net realisable value.

The New Zealand Accounting Standards Board ("the NZASB") has been made aware of the costs that some not-for-profit entities may have to incur to meet the requirements of PBE IPSAS 23 in relation to donated goods. In response to those concerns, the NZASB has issued Exposure Draft NZASB 2015-3 *Donated Goods (Amendments to PBE IPSAS 23)* ("the Exposure Draft").

The Exposure Draft proposes that entities not be required to recognise donated goods at the date of acquisition **where it is not practicable to reliably measure their fair value**. Where such goods weren't recognised at acquisition (with corresponding recognition in revenue), the revenue from the goods would be recognised when they were sold. This would mean that charity shops would be able to use the accounting treatment that most currently use – i.e. making the following journal entry at the time of sale:

Dr Cash (sale price)

Cr Revenue (sale price)

This would significantly reduce financial reporting costs for charity shops and other not-for profit entities that receive high volumes of low-value donated goods.

Determining whether it is practicable to reliably measure the fair value of donated goods will require the **application of professional judgement** and is a decision that will likely attract the attention of auditors. An entity will only be able to demonstrate that it is **not practicable** to reliably measure the fair value of goods donated to it where the cost of measuring the fair value of goods at the date of acquisition outweighs the benefits of doing so.

The NZASB is seeking comments on the Exposure Draft by 30 October 2015. Information on the Exposure Draft is available here. It's important that the NZASB hears from not-for-profit entities that would benefit from the amendment proposed by the Exposure Draft and we encourage such entities to make submissions.

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

BELOW-MARKET AND INTEREST-FREE LOANS

Loans made by one party to another party meet the definition of financial instruments under NZ IAS 32 – *Financial Instruments: Presentation* (NZ IAS 32) or PBE IPSAS 28 – *Financial Instruments: Presentation* (PBE IPSAS 28). The grantor of the loan, in most instances, would recognise the loan as a "loan and receivable". The recipient of the loan, in most instances, would recognise the loan as a financial liability at amortised cost.

On initial recognition, both the grantor and the recipient of the loan are required to measure the loan at **fair value** plus directly attributable transaction costs.

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. In normal situations, the fair value would be the transaction price, i.e., the fair value of the consideration given or received.

However, in circumstances where the loan is not of a short duration, and does not attract market rates of interest, then the consideration given or received is unlikely to be the fair value. This is because, in effect, part of the consideration given or received is to take into account the time value of money.

Short-term receivables and payables are commonly measured at the amount of consideration received as the effect of discounting (i.e. the time value of money) is, in most instances, not material.

For longer-term receivables and payables, however, fair value on initial recognition will need to be calculated. This is normally done by using a discounted cash flow valuation method to determine fair value whereby future cash flows are present valued using prevailing market interest rates for a similar loan at that point in time.

The difference between the calculated fair value and the consideration given or received is generally recognised in profit or loss, unless it qualifies for recognition as some other type of asset, liability or equity amount.

Example 1

- On 1 Jan 2015 Entity A lends Entity Z $100,000.
- The loan is for a period of 5 years.
- The loan does not attract interest.
- The prevailing market interest rate for similar types of loans is 10% per annum.
- Any difference between fair value and the consideration given or received does not qualify for recognition as some other type of asset, liability or equity amount

What should Entity A and Entity Z journal entries be at 1 Jan 2015 and 31 Dec 2015?

Answer:

In order to determine the fair value of the loan, Entity A and Entity Z need to take the following steps:

1. Determine the market interest rate for similar instruments (here: 10% p.a.)
2. Discount all cash flows from the loan with the market interest rate to arrive at their present value, which is the fair value of the loan on 1 Jan 2015.

Applying a simple Excel formula "NPV" or "net present value", as there is only one cash flow (repayment of the loan at the end of year 5). Simply type =NPV in the excel file and insert the following parameters:

- Rate = 0.10 (that's for 10% being the market interest rate)
- Value 1 = 0 (no payments made in year 1)
- Value 2 = 0 (no payments made in year 2)

- Value 3 = 0 (no payments made in year 3)
- Value 4 = 0 (no payments made in year 5)
- Value 5 = 100,000 (repayment of the principal in year 5)

Your formula should thus be =NPV(0.1,0,0,0,0,100000) and if you did it right, the fair value of the loan is $62,092.13.

For Entity A, the journal entry at 1 January 2015 would be:

	DR	CR
DR Loan receivable – Entity Z	$62,092.13	
DR P&L	$37,907.87	
CR Cash		$100,000

For Entity Z, the journal entry at 1 January 2015 would be:

	DR	CR
DR Cash	$100,000	
CR P&L		$37,907.87
CR Loan payable – Entity A		$62,092.13

Both entities would record the difference between fair value and the consideration given or received in profit or loss.

At 31 December 2015, both entities will need to impute interest at the effective interest rate on the loan (in this instance the market rate used of 10%).

For Entity A, the journal entry at 31 December 2015 would be:

	DR	CR
DR Loan receivable – Entity Z	$6,209.21	
DR P&L		$6,209.21

For Entity Z, the journal entry at 31 December 2015 would be:

	DR	CR
DR Interest Expense P&L	$6,209.21	
CR Loan payable – Entity A		$6,209.21

Both entities would impute interest of 10% on the loan balance for the period, based on the fair value at initial recognition. (I.e. $62,092.13 x 10%)

Example 2

- Assume the same fact pattern as for Example 1, except that Entity A is Entity Z's parent company.

What should Entity A and Entity Z journal entries be at 1 Jan 2015?

Answer

- Due to the parties being related, there is an argument to say that the amount of the consideration that relates to the time value of money is an additional investment of Entity A in its subsidiary Entity Z, and thus:

For Entity A, the journal entry at 1 January 2015 would be:

	DR	CR
DR Loan receivable – Entity Z	$62,092.13	
DR Investment in Entity Z	$37,907.87	
CR Cash		$100,000

The increased investment in Entity Z would need to be assessed for impairment in accordance with NZ IAS 36 – *Impairment of Assets* at Entity A's reporting date.

For Entity Z, the journal entry at 1 January 2015 would be:

	DR	CR
DR Cash	$100,000	
CR Capital contribution from Entity A		$37,907.87
CR Loan payable – Entity A		$62,092.13

Example 3

- On 1 January 2015, Company D grants a loan to its subsidiary, Company F, for $100,000 at an interest rate of 5% p.a for a period of 3 years.
- Only interest is payable in year 1 and year 2, with the principal also being repaid in year 3.
- The market rate of interest on similar loans is 10%.
- How should Company D and Company F account for this loan on 1 January 2015 and 31 December 2015?

Answer:

In order to determine the fair value of the loan, Entity D and Entity F need to take the following steps:

i. Determine the market interest rate for similar instruments (here: 10% p.a.)

ii. Discount all contractual cash flows from the loan with the market interest rate to arrive at their present value, which is the fair value of the loan on 1 Jan 20x5.

iii. Recognise the difference between the consideration paid/received (face value) and fair value of the loan as an additional investment in Company F.

Applying a simple ***Excel formula*** "**NPV**" or "**net present value**", to the actual contractual cash flows (with repayment of the loan at the end of year 3). Simply type =NPV in the excel file and insert the following parameters:

- Rate = 0.10 (that's for 10% being the market interest rate)
- Value 1 = 5,000 (contractual interest payment made in year 1)
- Value 2 = 5,000 (contractual interest payment made in year 2)
- Value 3 = 105,000 (contractual interest payment and return of principal made in year 3)

Your formula should thus be =***NPV(0.1,5000,5000,105000)*** and if you did it right, the fair value of the loan is **$87,565.74.**

For Entity D, the journal entry at 1 January 2015 would be:

	DR	CR
DR Loan receivable – Entity F	$87,565.74	
DR Investment in Entity F	$12,434.26	
CR Cash		$100,000

For Entity F, the journal entry at 1 January 2015 would be:

	DR	CR
DR Cash	$100,000	
CR Equity contribution from parent Entity D		$12,434.26
CR Loan payable – Entity D		$87,565.74

Both entities would record the difference between fair value and the consideration given or received as an increased investment in Company F.

At 31 December 2015, both entities will need to **impute interest** at the effective interest rate on the loan (in this instance the market rate used of 10%) based on the fair value at initial recognition. This will differ from the contractual interest cash received of $5,000 p.a.

For Entity D, the journal entry at 31 December 2015 would be:

	DR	CR
DR Loan receivable – Entity F	$8,756.57	
CR Interest income P&L		$8,756.57

(Interest for P&L purposes is calculated based on market rate of 10%p.a. – i.e. $87, 565.74 x 10%)

	DR	CR
Dr Cash	$5,000	
Cr Loan receivable – Entity F		$5,000

(Cash receipt of contractual interest payment on $100,000 face value of loan at contractual interest rate of 5%p.a.)

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For Entity F, the journal entry at 31 December 2015 would be:

	DR	CR
DR Interest expense P&L	$8,756.57	
CR Loan payable – Entity D		$8,756.57

(Interest for P&L purposes is calculated based on market rate of 10%p.a. – i.e. $87, 565.74 x 10%))

	DR	CR
Dr Loan payable – Entity D	$5,000	
Cr Cash		$5,000

(Cash receipt of contractual interest payment on $100,000 face value of loan at contractual interest rate of 5%p.a.)

Based on the above methodology, the balance of the loan will be:

Date	Balance of loan	Calculation
1 Jan2015	$87,565,74	NPV(0.01,5000,5000,105000)
31 Dec 2015	$91,322.31	$87,565.74 + ($87,565.74x10%) - $5,000
31 Dec 2016	$95,454.55	$91,322.31 + ($91,322.31x10%) - $5,000
31 Dec 2017 (immediately prior to repayment)	$105,000	$95,454.55 + ($95,454.55x10%)

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

GOING CONCERN DISCLOSURES

In recent years, management's assessment of the validity of the going concern assumption has received increased focus.

In some instances when the financial statements are being prepared, there are events or conditions that may cast significant doubt over the entity's ability to continue as a going concern. In preparing the financial statements, management needs to consider those events and conditions and reach a conclusion on whether the going concern assumption remains valid.

The going concern assumption is not valid

Where the going concern assumption is not valid, the entity must not prepare financial statements on a going concern basis. Instead:

- All assets and liabilities will be classified as current
- Assets will be measured at the lower of their carrying amount and realisable value
- Liabilities will be measured at the amount expected to be required to settle them (and in some instances onerous contracts will arise and be recognised as liabilities).

If the entity still wants to claim compliance with the relevant accounting framework and generally accepted accounting practice, care must be taken to ensure that the requirements of applicable accounting standards are not breached. For example, an entity could not recognise expenses that had not been incurred at balance date (i.e. it could not accrue for any anticipated future expenses).

The going concern assumption is valid, but there are material uncertainties in relation to it

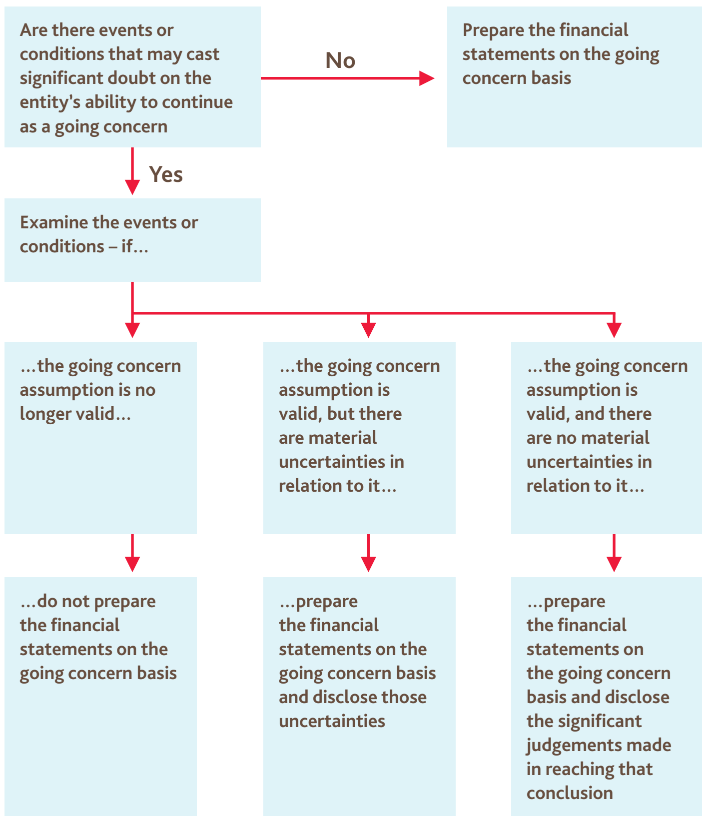
Where the going concern assumption remains valid, and there are no material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, management must determine what to disclose in the financial statements.

The International Financial Reporting Standards Interpretations Committee has recently considered this issue and concluded that, **where management has applied significant judgements** in determining that the going concern assumption is valid and that there are no material uncertainties about going concern, those judgements are **key judgements** that must be disclosed. This disclosure requirement exists for:

- Tier 1 for-profit entities (i.e. those for-profit entities reporting under full New Zealand equivalents to International Financial Reporting Standards ("NZ IFRS"))
- Tier 2 for-profit entities (i.e. those for-profit entities reporting under the NZ IFRS Reduced Disclosure Regime
- Public benefit entities ("PBEs") applying full NZ IFRS with PBE modifications ("NZ IFRS PBE").

When PBEs move from NZ IFRS PBE to the new suite of PBE accounting standards, this disclosure requirement will apply to Tier 1 PBEs (i.e. those PBEs applying full PBE accounting standards) and Tier 2 PBEs (i.e. those PBEs applying PBE accounting standards under the Reduced Disclosure Regime).

Thus, the process and its possible outcomes are:



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

DISCLOSURE OF FEES PAID TO AUDITORS

FRS-44 *New Zealand Additional Disclosures* ("FRS-44") requires entities to separately disclose fees paid to each auditor or reviewer for:

- The audit or review of the financial statements
- Other services performed.

Where other services are provided, the entity is also required to describe the nature of those services.

This requirement only applies to:

- Tier 1 for-profit entities (i.e. those for-profit entities reporting under full New Zealand equivalents to International Financial Reporting Standards ("NZ IFRS"))
- Public benefit entities ("PBEs") applying full NZ IFRS with PBE modifications ("NZ IFRS PBE"). When PBEs move from NZ IFRS PBE to the new suite of PBE accounting standards, this requirement will apply to Tier 1 PBEs (i.e. those PBEs applying full PBE accounting standards), but will be located in PBE IPSAS 1 *Presentation of Financial Statements*.

The Financial Markets Authority ("the FMA") has recently released a report into its most recent examination of the disclosure by listed issuers of fees paid to auditors.

This report follows on from a review of audit fee disclosures that the FMA published in April 2014. In that report, the FMA:

- Concluded that there were inconsistencies in the manner in which the reviewed entities disclosed the fees paid to the auditor for the audit or review of financial statements and the non-audit fees paid to the auditor
- Noted that the fee for audit of the financial statements should include all costs associated with the annual audit of the financial statements and the review of the interim financial statements and nothing else
- Noted instances of disclosure of audit fees not meeting the minimum requirements of FRS-44, principally due to absent or poor explanation of the nature of other services provided.

The FMA's April 2014 report also provided the following example of good disclosure of fees paid to the auditor and stated that it encourages entities to provide disclosure to this level of detail:

Fees paid to auditor	**2013 $'000**	**2012 $'000**
Audit of financial statements		
Audit and review of financial statements (note 1)	540	525
Other services		
Regulatory audit work (note 2)	60	55
Other assurance services (note 3)	20	15
Tax services (note 4)	85	75
Other services (note 5)	180	200
Total fees paid to auditor	720	725

i. The audit fee includes the fees for both the annual audit of the financial statements and the review of the interim financial statements.

ii. Regulatory audit work consists of the audit of regulatory disclosures.

iii. Other assurance services comprise reporting on trust deed requirements.

iv. Tax services relate to tax compliance work.

v. Other services in 2013 comprise an agreed upon procedures engagement. In 2012 this fee was for due diligence work on the acquisition of a new subsidiary.

In its most recent review of audit fee disclosures, the FMA noted "a marked improvement in the quality of disclosure of fees paid to the external auditor", with 84% of the sample reviewed meeting the disclosure requirements of FRS-44.

The report also encouraged all issuers to disclose, in their annual reports, the process followed by the audit committee in managing the relationship with the external auditor. The types of disclosures that the FMA considers useful include:

- Explanations of the audit committee's policies in appointing and re-appointing the auditor
- How the external auditor's independence is reviewed by the committee
- The policy of approval of non-audit services.

The full report is available here. The April 2014 report is available here.

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

ATTENTION ALL TIER 1 AND TIER 2 PBE REPORTING ENTITIES - ACCOUNTING STANDARDS AMENDED FOR THE DISCLOSURE INITIATIVE AND OTHER MATTERS

The External Reporting Board (XRB) has issued two PBE Accounting Standards: *Disclosure Initiative* (Amendments to PBE IPSAS 1) and 2015 *Omnibus Amendments to PBE Standards*.

Disclosure Initiative (Amendments to PBE IPSAS 1)

This Standard clarifies existing requirements in PBE IPSAS 1 *Presentation of Financial Statements* and encourages Tier 1 and Tier 2 PBEs to apply professional judgement in determining what information to disclose in their financial statements.

PBEs are encouraged to focus disclosures on what is most relevant and important to users, grouping disclosures of related items to enhance understandability and remove immaterial disclosures, thereby reducing disclosure overload in financial statements.

The amendment is applicable for periods beginning on or after 1 January 2016. Earlier application is permitted for not-for-profit PBEs as long as the full suite of PBE Standards is applied at the same time. Public sector PBEs can apply the Standards early for annual financial statements covering periods beginning on or after 1 April 2015.

2015 Omnibus Amendments to PBE Standards

This Standard amends the PBE Accounting Standards for the following reasons:

a) to align the following PBE standards with various amendments to NZ IFRSs as a consequence of the IASB's Annual Improvements to IFRSs;

   i. PBE IPSAS 16 *Investment Property* (determining whether the acquisition of an investment property is a business combination under PBE NZ IFRS 3
   ii. PBE IPSAS 20 *Related Party Disclosures* (expanding the definition of related parties to include entities providing key management personnel services along
   iii. PBE IFRS 3 *Business Combinations* (providing guidance for the accounting treatment of contingent consideration that meets the definition of a financial instrument as well as those that do not);
   iv. PBE IFRS 5 *Non-current Assets Held for Sale and Discontinued* Operations (to include guidance on of assets (or disposal groups) held for distribution to owners); and
   v. PBE IPSAS 34 *Interim Financial Reporting* (introducing the ability to cross-reference to accompanying information in interim reports.

b) to align the following PBE standards with some changes to IPSASs as a consequence of the IPSASB's *Improvements to* IPSASs 2014; and

   i. PBE IPSAS 1 *Presentation of Financial Statements* (clarifying requirements for comparative information);
   ii. PBE IPSAS 17 *Property, Plant and Equipment* (clarification of the accounting treatment of servicing equipment, carrying amount and accumulated depreciation on revalued items and acceptable methods of depreciating property, plant and equipment assets);
   iii. PBE IPSAS 28 *Financial Instruments: Presentation* (clarification of the tax effect of distributions to holders of equity instruments); and
   iv. PBE IFRS 5 *Non-current Assets Held for Sale and Discontinued* Operations (to include guidance on of assets (or disposal groups) held for distribution to owners); and

c) for editorial corrections.

This standard is effective for annual financial statements covering periods beginning on or after 1 January 2016. Not-for-profit PBEs can apply the Standards early, as long as they apply the full suite of PBE Standards at the same time. Public sector PBEs can apply the Standards early for annual financial statements covering periods beginning on or after 1 April 2015.

Copies of these standards can be accessed on the XRB's website 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 Contacts with Customers* on the manufacturing; retail; telecommunications, software; media, construction-real estate and professional services industries.
- **Summaries on a Page (SOAPs)** contain summaries of NZ IFRS Standards for for-profit entities and PBE Standards for public sector and not-for profit entities currently in effect in New Zealand.

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

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

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

KEY CONTACTS

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

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

WAIKATO
Bernard Lamusse
T: +64 7 839 2106

TAURANGA
Fraser Lellman
T: +64 7 571-6280

ROTORUA
Judith Stanway
T: +64 7 347 9087

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

TARANAKI
Steve Waite
T: +64 6 759 9034

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

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

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

INVERCARGILL
Greg Thomas
T: +64 3 218 2959

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