2.1 Changes In Financial Reporting Standards

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2.101 For many years local authorities have been required to present their financial statements in accordance with generally accepted accounting practice *(GAAP). GAAP* means:

- approved financial reporting standards, so far as those standards apply to the local authority; and
- in relation to matters for which no provision is made in approved financial reporting standards and that are not subject to any applicable rule of law, accounting policies that are appropriate in relation to the circumstances of the local authority and have authoritative support within the accounting profession in New Zealand.

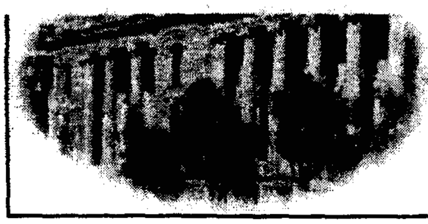
2.102 The Accounting Standards Review Board (ASRB) has responsibility under the Financial Reporting Act 1993 to approve financial reporting standards. All existing financial reporting standards have been developed by the Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand (FRSB) before being approved by the ASRB.

2.103 For the last decade, financial reporting standards in New Zealand have been sector-neutral. Sector-neutral standards are standards developed with regard to,, and which establish standards and guidance for, the full range of entities to which they apply. The credibility of our public sector financial reporting has undoubtedly been enhanced by the fact that the same standards *are* applied by all entities.

2.104 In December 2002, the ASRB announced its decision that New Zealand entities would be required to apply new standards based on International Financial Reporting Standards (IFRS)[1] for reporting periods beginning on or after 1 January 2007. Entities would have the option to apply the new standards from periods starting 'on or after 1 January 2005. The timetable was driven by a desire to allow the corporate sector in New Zealand to make the transition, if desired, at the same time as Australia and Europe.

1 The term IFRS is used to refer to International Accounting Standards Board (IASB) standards. The standards comprise

- International Accounting Standards (IASs), inherited by *the* IASB *from* its predecessor body, the International *Accounting* Standards Committee (IASC), and the interpretations *of those* standards
- International Financial Reporting Standards (IFRSs) - the new standards being issued by the IASB, and the interpretations of those standards.



2.105 IFRS apply only to profit-oriented entities. We understand that the new New Zealand standards to be based on IFRS will be called New Zealand International Financial Reporting Standards (NZ IFRS).[2] The format, language, and structure of IFRS will be preserved in NZ IFRS but the ASRB has decided that a single set of standards should exist in New Zealand for application to all entities.

2.106 Retention of a single set of standards retains some of the benefits of sector-neutral standards, most notably efficiency in application of the standards (in that preparers and auditors will have a better understanding of a single set of standards) and efficiency in preparation of standards.

2.107 In order that the standards can be applied by what the ASRB calls public benefit entities[3] (including almost all public sector entities), additional measurement and recognition requirements will be introduced, and additional or amended disclosure requirements may be established. It is possible that additional or amended disclosure requirements may apply to profit-oriented entities as well.

2.108 In June 2003, we raised concerns with the ASRB that inadequate consideration was being given to the effects of the changes to standards on public sector reporting in New Zealand After discussion, the ASRB established the following guidelines to be used in adapting IFRS in New Zealand:

- The IFRS disclosure requirements cannot be reduced for profit-oriented entities.
- Additional disclosure requirements can be introduced for all entities.
- The IFRS recognition and measurement requirements for profit-oriented entities cannot be changed.
- Recognition and measurement requirements can be amended for public benefit entities, with a rebuttable presumption that amendments will be made for differences between IFRS and the corresponding International Public Sector Accounting Standard (IPSAS)[4] or existing New Zealand-developed Financial Reporting Standards (FRS) based on the IPSAS or FRS as applicable.

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2 NZ IFRS will comprise:
- New Zealand International Accounting Standards (NZ IASs), and the interpretations of those standards.
- New Zealand International Financial Reporting Standards (NZ IFRSs), and the interpretations of those standards.

3 Public benefit entities are entities whose primary objective is to provide goods or services for a community or a social benefit, and where any risk capital has been provided with a view to supporting that primary objective rather than for the financial return to equity shareholders.

4 IPSAS are developed and issued by the Public Sector Committee of the International Federation of Accountants for application to public sector entities.

- Introduction of guidance materials for public benefit entities should be based on the Same principles as apply to introduction of recognition and measurement requirements as outlined above.
- Elimination of options in IFRS is permitted for all entities, on a case-by-case basis. Where an IFRS permits options that are not allowed in existing FRS, a strong argument would need to be made in order for the ASRB to agree to the retention of such options in the NZ IFRS In reaching a view on this issue, the ASRB will be mindful of the approach adopted by the Australian Accounting Standards Board.

2.109 During the past year, the FRSB has been developing the new standards to be based on IFRS To date it has issued 37 exposure drafts of new standards, typically with each exposure draft being available for a two-month period for public comment.

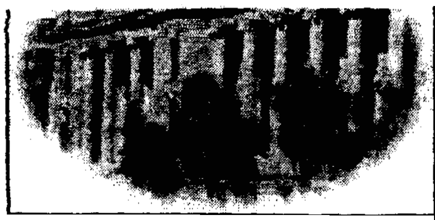
2.110 It is unclear at present exactly what the new standards will mean for local authorities and other public sector entities. The full effect will become clearer towards the end of 2004. But, as further changes will be made in IFRS for application in 2006 and beyond, there may be further effects by the time local authorities and other public sector entities need to comply with the new standards for the first time.

2.111 We expect the majority of public sector entities to adopt the new standards for their first reporting period beginning on or after 1 January 2007. However, we expect local authorities will adopt these standards for their reporting period beginning 1 July 2006. This is because:

- councils are required to produce long-term council community plans (LTCCPs) by 30 June 2006 covering a minimum of 10 years starting 1 July 2006. Councils will subsequently be required to report against these plans.
- councils will want to avoid having to present information under two different sets of standards in the one LTCCP. If Councils delay adoption until the latest possible date, then the first year of their 2006 LTCCP will be under the old standards, with the remaining nine years under the new standards.

2.112 Leaving adoption of the new standards until the year ending 30 June 2007 will still require local authorities to restate their opening statement of financial position as at 1 July 2005. This is necessary because the financial statements for the year ending 30 June 2007 must include comparative information for the 30 June 2006 year using the new standards.

5 One of the functions of the ASRB is to liaise with the Australian Accounting Standards Board with a view to harmonising New Zealand and Australian financial reporting standards (section 24, Financial Reporting Act 1993).



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Our Concerns

2.113 We have a number of concerns about the transition to the new standards, including:

- the process being followed;
- the possible content of the standards; and
- the effect on the local government sector.

The Transition Process

2.114 In order to meet the same timetable as adopted in Australia and Europe, the new standards need to be in place in the very near future to enable entities to comply for periods starting on or after 1 January 2005 (necessitating an opening statement of financial position at 1 January 2004 for the earliest adopters). This has meant the complete set of standards is being changed in an 18-month period. This tight timetable has placed enormous pressure on the accounting standard setting boards (the ASRB and FRSB) but has, in our view, placed an impossible burden on those being asked to comment on the standards. As a result, the number of submissions has been very low.

2.115 For example, the Society of Local Government Managers' Financial Management Working Party has been able to comment on only one or two of the standards, because of the pressures generally being faced by the sector over recent months.

2.116 We have commented on almost all of the standards, but the breadth and depth of our consideration has been less than for previous new standards. We acknowledge and accept responsibility on behalf of the broader public sector to consider the effect of the proposed standards, but we have found it difficult to contribute at the level we would have liked. The end result of the speed of the process must inevitably be that the quality of the final standards is compromised.

Possible Content of the Standards

2.117 Notwithstanding the establishment of the ASRB Guidelines described in paragraph 2.108 *(see pages **30-31**),* we *still* have concerns that the **issues** relevant to public sector entities are not *being* given sufficient consideration at the appropriate point in the process. In our view, lack of appropriate consideration could lead to standards being issued that contain inappropriate requirements for public sector entities or do not have sufficient guidance to ensure appropriate and consistent application of some requirements.

2.118 There have been exposure drafts issued with proposed requirements for public sector entities that simply do not **make** *sense.* **A** good example of such **an** exposure draft is ED NZ **IAS 16:** Property, ***Plant and Equipment.*** The exposure **draft** proposed that:

- where property, plant **and** equipment are revalued, there would **be** disclosure of the carrying amount that would have been recognised **had** the **assets** been carried under the cost **method;** and
- revaluation movements would be accounted for on **an** individual basis rather than **within** *classes* (groups) of **assets.**

2.119 Many public sector entities do not have the records to enable them to disclose, for assets that **are** revalued, **the carrying** amount of **those** assets under the cost **method.** In **any** event, we see no value in that disclosure for users **of financial reports.** The expense of seeking to obtain the cost information, or some arbitrary alternative based on the carrying value when first adopting accrual accounting or **NZ IFRS,** cannot meet any cost/benefit test that might be applied.

2.120 **Accounting** for revaluation movements on **an** individual asset basis may not be able to be done by public sector entities because of a lack of information held in relation to individual asset movements in the **past.** There **was** no requirement for **such information** to be held.

2.121 We and others have argued **strenuously** against these proposals. We now understand that both of these proposed requirements **will** be changed in the final standard so that they are optional for public sector entities. **Such** changes are very welcome.

2.122 However, given that these two **matters** were considered in the development **of** the current New Zealand Financial Reporting Standard – **FRS-3:** *Accounting for **Property, Plant and Equipment*** – and the **International** Public Sector Accounting Standard – **IPSAS 17:** ***Property, Plant and Equipment*** – and were not requirements in either of those standards, we question ***the*** **robustness** of the process for development **of** the exposure drafts of NZ **IFRS. It** appears that the requirements applicable to profit-oriented entities were to be imposed on public benefit entities without regard to their different circumstances.

2.123 There have also been exposure *drafts* **issued** that **do** not retain the extensive and valuable guidance in current New Zealand financial reporting standards that are of relevance particularly **to public** sector entities. **Again,** a good example of ***such*** an exposure ***draft*** is ED **NZ** IAS 16. **It** is proposed that that exposure draft contain **only** some **of** the extensive valuation guidance currently in **FRS-3.** We **are** concerned that invaluable guidance, built up over a decade based on our experience as the first country to apply accrual accounting in the public sector, could disappear on approval of a new standard.

2.124 We are also concerned about **the** likely content **of** other standards, including, in particular, the standard dealing with consolidations. Our existing standards **FRS-36:** ***Accounting for Acquisitions Resulting*** *in Combinations* ***of*** **Entities** *or* Operations, **and FRS-37** *Consolidating Investments* ***in Subsidiaries*** include extensive guidance that has **been** built **up through the** experience **of** applying consolidation principles in **the** public **sector** over the last decade. The nature **of relationships** and arrangements between entities frequently differs markedly between the public sector and the private sector, ***so*** this guidance **can** be and **has** proven very useful in seeking to apply the standards.

2.125 **We** are concerned at the **risk** that much **of** *this* guidance may be ***lost,* and that** there could be broader effects – for example, in regard to the Auditor-General's mandate, which is determined by the definition of public entities in the **Public** Audit **Act** 2001. That definition relies in part on the requirements of **any** approved **financial** reporting standard (currently **FRS-37). It** is important that any such broader issues **are** properly considered in the development of the standards.

Effect on the Local Government Sector

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2.126 We are also concerned about the effect of the change to NZ IFRS on local authorities and other public sector entities. The change has been driven by profit-oriented entities operating in international markets or which have subsidiaries in other jurisdictions or which are subsidiaries of companies in other jurisdictions. In our view, the change to NZ IFRS will not result in any immediate net benefits to the users of financial reports of public sector entities.

2.127 We acknowledge that the adoption of IFRS-based standards will fill some gaps in the existing financial reporting requirements. The most notable gaps filled include recognition and measurement of financial instruments and accounting for revenue of an exchange nature. Standards on these matters are welcome.

2.128 However, important issues of relevance to the users of reports of public sector entities – such as how to properly account for non-exchange transactions and how to report broader (non-financial) measures of performance – have received no attention in the past few years. The latter has been a concern to us for many years and we are disappointed at the absence of any progress.

2.129 The change to NZ IFRS raises concerns because it will:

- force all public sector entities to focus once again on the core financial aspects of their reporting rather than the more complex and broader aspects of performance reporting;
- demand additional training of entities and auditors to enable the change to be made in a reasonable fashion;
- result in costs – costs which will arise without concomitant benefits for most public sector entities; and
- require effort without any real improvement in the quality of information for users of the reports of public sector entities.

2.130 We are also concerned at the absence of guidance to local authorities in meeting some new reporting obligations under the Local Government Act 2002. For example, there is no guidance available on the preparation of summary LTCCPs and annual plans, and the guidance in FRS-29: *Prospective Financial Information*, which applies to LTCCPs, is deficient in a number of respects. It has been necessary for us recently to draw the issues in relation to FRS-29 to the attention of the FRSB (see paragraphs 3.213-3.214 on pages 95-96).

2.131 A significant concern in relation to local authorities is the capability of the sector to cope with extensive change in 2005 and 2006. The 2005 annual report of each council will be required to be completed by 31 October 2005, a month earlier than the reporting requirement has been in the past. In addition, all councils will be required to present a summary of their annual report in 2005. Furthermore, most councils will be starting extensive work during 2005 to enable them to prepare their first audited LTCCP in the early part of 2006. The need to establish an opening statement of financial performance under new standards at 1 July 2005 will further compound the issues and challenges.

Summary

2.132 We have made a major and ongoing commitment to the quality of financial reporting by public sector entities. We will continue to do so through representation on the FRSB by providing guidance to auditors on new requirements, and by making submissions on proposals which may affect public sector entities.

2.133 However, we are concerned that the speed of the process, and the limited consideration of the needs of the users of public sector reports, will adversely affect the quality of reporting over the coming years. We are also concerned about the capability of the local authority sector to respond to the extent of change expected of it in 2005 and 2006.

2.134 We will continue to monitor developments and work with the sector as best we are able. To this end, the Auditor-General has recently established a Project Steering Committee to lead our response to the change to NZ IFRS.

2.135 Notwithstanding the many challenges being faced, we encourage the local government sector to give appropriate attention to the change to NZ IFRS during the period ahead.

6 Nine councils, which were "early adopters" of new requirements in the Local Government Act 2002 in 2003, must meet this requirement in 2004.

7 As the Auditor-General is the auditor of the Accounting Standards Review Board, no member of the Auditor General's staff is able to be a member of that Board, so our input is made through the FRSB.