Controller and Auditor-General
Tumuaki o te Mana Arotake

Discussion paper

The Auditor-General's views on setting financial reporting standards for the public sector

Office of the Auditor-General
PO Box 3928, Wellington 6140

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

Email: reports@oag.govt.nz
www.oag.govt.nz

The Auditor-General's views on setting financial reporting standards for the public sector

This is a discussion paper produced under section 21 of the Public Audit Act 2001.

June 2009

ISBN 978-0-478-32631-4

Hon Dr Lockwood Smith MP
Speaker
House of Representatives
WELLINGTON

Mr Speaker

I am pleased to forward this report to you for presentation to the House of Representatives under section 21 of the Public Audit Act 2001.

Yours faithfully

K B Brady
Controller and Auditor-General

Wellington

17 June 2009

Contents

Part 1
Auditor-General's introduction

1.1 The purpose of this discussion paper is to set out:

- my views on setting financial reporting standards for the New Zealand public sector;
- my views on setting financial reporting standards internationally;
- my concerns about financial reporting standards for the New Zealand public sector (including concerns about specific standards applying to most public sector entities and expected future changes to standards); and
- my views on changes that are needed to provide a better basis for public sector financial reporting standards in New Zealand.

1.2 In setting out my views, I want to make Parliament aware of my concerns and what it can do to help bring about change. I also hope the discussion paper will promote constructive debate about the changes needed to the approach to setting financial reporting standards, particularly for the public sector.

A summary of my views

1.3 I am disappointed with the overall quality of financial reporting standards applying to most entities in the public sector. In my view, the approach to setting financial reporting standards needs to change to ensure that appropriate standards apply to public sector entities, so that those entities' financial statements will meet the needs of people using them.

1.4 For the past 6½ years, most financial reporting standards issued in New Zealand have been based on International Financial Reporting Standards (IFRS).[1] IFRS have been put in place by the International Accounting Standards Board for application by large profit-oriented entities accessing capital markets. The Financial Reporting Standards Board, a committee of the New Zealand Institute of Chartered Accountants, has established New Zealand equivalents to IFRS (NZ IFRS)[2] for application by reporting entities whether profit-oriented or not. The Accounting Standards Review Board, an independent Crown entity, has approved NZ IFRS

1 IFRS refers to standards and interpretations issued by the International Accounting Standards Board. The standards and interpretations comprise:
- International Accounting Standards (IAS), adopted by the International Accounting Standards Board from its predecessor body, the International Accounting Standards Committee, and interpretations of those standards established by the former Standards Interpretations Committee; and
- International Financial Reporting Standards (IFRS), which are the new standards created by the International Accounting Standards Board, and interpretations of those standards established by the International Financial Reporting Interpretations Committee.

2 NZ IFRS refers to standards and interpretations issued by the Financial Reporting Standards Board and approved by the Accounting Standards Review Board. The standards and interpretations comprise:
- The New Zealand equivalents to IFRS (that is, the New Zealand equivalents to the standards and interpretations issued by the International Accounting Standards Board); and
- New Zealand-created standards on topics not addressed by the International Accounting Standards Board.

for application by certain reporting entities, which includes most entities in the public sector.

1.5 Taking standards created by the International Accounting Standards Board for one purpose and using them for another purpose relies on relevant and appropriate changes being made to IFRS. Unfortunately, there have been few changes and little guidance included in NZ IFRS to assist public sector entities to apply the new standards.

1.6 I am concerned about the lack of changes and the lack of guidance for the public sector, particularly given IFRS contain a lot of guidance and examples for circumstances and transactions common to profit-oriented entities. I am concerned because of the adverse effect that deficiencies in financial reporting standards can have both on the quality of financial reports prepared by public sector entities, and on the costs of doing so.

1.7 My comments about NZ IFRS should not be taken as a criticism of IFRS. I support the adoption of IFRS by listed issuers in New Zealand and any other profit-oriented entities required to, or wishing to, state their compliance with IFRS. Adopting IFRS makes sense for those entities, because IFRS are designed primarily for profit-oriented entities accessing capital markets.

1.8 During the past few years, I have been calling for sensible changes to be made to IFRS when creating NZ IFRS. I am disappointed that my calls have, mostly, not resulted in the changes I consider are needed. This lack of change has resulted in some instances where NZ IFRS are difficult to apply in the public sector, and where information in financial statements is of questionable relevance to those people using it.

1.9 I am also aware of impending changes to IFRS by the International Accounting Standards Board that are likely to make IFRS even more difficult to apply by most public sector entities. These impending changes also raise more questions about the relevance of information for people using public sector entities' financial statements.

1.10 At the end of 2008, I decided that the best action I could take was to withdraw my staff from the process for setting financial reporting standards and report my concerns to Parliament. My regret at withdrawing staff was outweighed by a concern that continuing to involve my staff would add credibility to a process that, in my view, should not be given. I was also concerned that continued involvement was not a good use of the scarce resources of my Office.

1.11 I do not want my disappointment with the quality of standards to imply that there is generally poor quality financial reporting by public sector entities in New Zealand. In my view, despite the quality of the standards, public sector entities mostly report meaningful financial information. Also, despite the quality of the standards, financial reporting by entities in the New Zealand public sector is still well regarded internationally. I am advocating change now to ensure that the New Zealand public sector does not lose its reputation.

1.12 It is important that Parliament is aware of my concerns and the changes that I think are needed to ensure that relevant and appropriate financial reporting standards are put in place for the public sector. If Parliament shares my concerns, it can help to bring about some of the changes.

1.13 I consider there now needs to be a significant change to the way financial reporting standards are set for the public sector. This is likely to include taking more account of the work of the International Public Sector Accounting Standards Board.[3] The focus for change needs to be on relevant and appropriate financial reporting standards that are designed to produce financial reports that are understandable and can be used by people to properly hold public sector entities to account.

Why financial reporting standards are important

1.14 Financial reporting standards are important because they set the requirements for preparing financial statements. These requirements are collectively referred to as generally accepted accounting practice. Financial statements are an important part of the accountability documents prepared by entities in the public sector. Therefore, financial reporting standards play a crucial role in the accountability of entities in the public sector.

1.15 Parliament has decided, through legislation, that most entities in the public sector must prepare financial statements that comply with generally accepted accounting practice. Financial statements usually cover a period of one year and provide information about past transactions and events. Typically, entities in the public sector compare historical financial information about past transactions and events with the financial information budgeted at the beginning of the year.

1.16 The financial statements required by generally accepted accounting practice need to be relevant and appropriate for financial accountability purposes. Financial statements are made publicly available to partly fulfil an entity's accountability responsibilities.

3 The International Public Sector Accounting Standards Board is a part-time international standard-setting board that serves the public interest by creating financial reporting standards known as International Public Sector Accounting Standards (IPSAS) for use by public sector entities around the world.

1.17 Non-financial performance information is also a crucial part of the accountability documents prepared by many entities in the public sector. Non-financial performance information needs to work in conjunction with financial information to convey a coherent and consistent picture about each public sector entity's performance.

1.18 It is important that financial reporting standards result in financial information that can be readily integrated with non-financial performance information. Financial and non-financial performance information needs to be integrated, because true accountability requires transparency about financial and non-financial performance and an appropriate relationship between the two.

1.19 If there are deficiencies in financial reporting standards for the public sector, the likely consequences include:

- The information in financial statements may be unduly complex, both for those preparing the financial statements and for those using them. Undue complexity is particularly a problem for smaller public sector entities with limited resources and for those without a high degree of financial literacy.
- Transactions and events may be accounted for inappropriately or differently by different entities. Inappropriate or different accounting can adversely affect both the ability of people to understand financial statements and their ability to compare information between periods and, where relevant, across entities. The adverse effects could ultimately lead people to question the reliability and usefulness of financial statements.
- The information in financial statements may not be readily integrated with non-financial performance reporting. If this happens, people will not have a meaningful picture of an entity's performance with which to hold it to account.

Scope of this discussion paper

1.20 My views and concerns in this discussion paper are based on:

- many and varied dealings my staff and I have had relating to financial reporting standards, particularly during the past 6½ years; and
- documents my staff and I have read relating to financial reporting standards during that time.

1.21 The dealings my staff and I have had include:

- involvement in setting financial reporting standards in New Zealand and internationally through membership of various boards and working groups;
- correspondence and discussions with the Financial Reporting Standards Board and the Accounting Standards Review Board;

- liaison with audit offices in Australia; and
- the audit of public sector entities' financial statements based on NZ IFRS.

1.22 The documents my staff and I have read include:

- draft proposals,[4] discussion papers, and other documents published by the Financial Reporting Standards Board, the International Accounting Standards Board, and the International Public Sector Accounting Standards Board;
- NZ IFRS;
- public sector entities' financial reports; and
- articles in accounting journals and academic papers.

1.23 This discussion paper is focused primarily on financial reporting standards for public benefit entities in the public sector. The definition of public benefit entities includes most entities in the public sector.[5] Public sector entities that are not public benefit entities are generally companies, such as state-owned enterprises, port companies, energy companies, and company subsidiaries of public sector entities.

1.24 Although the discussion paper focuses on public benefit entities in the public sector, some of the matters discussed may have implications for profit-oriented entities in both the public and the private sectors, and public benefit entities in the not-for-profit sector. Such implications are unavoidable given there are currently common financial reporting standards affecting the financial reporting by entities in all sectors.

4 A draft proposal is usually issued for public comment as an "exposure draft".

5 Public benefit entities are defined as reporting entities whose primary objective is to provide goods or services for community or social benefit, and where any equity has been provided with a view to supporting that primary objective rather than for a financial return to equity holders. Public benefit entities in the public sector include such entities as government departments, district health boards, tertiary education institutions, schools, fish and game councils, other Crown entities, local authorities, licensing trusts, cemeteries, administering bodies, and Māori trust boards.

Part 2
Setting standards in New Zealand

2.1 In this Part, I comment on setting financial reporting standards for the New Zealand public sector. I also include my assessment of the financial reporting standards now in place for the public sector.

Setting financial reporting standards until late 2002

2.2 Until late 2002, financial reporting standards were created in New Zealand for application by all entities preparing general purpose financial reports. The Financial Reporting Standards Board, a committee of the New Zealand Institute of Chartered Accountants, wrote the standards. The standards created until 1993 were known as statements of standard accounting practice (SSAP).

2.3 In 1993, the Accounting Standards Review Board was established as an independent Crown entity in accordance with the Financial Reporting Act 1993. The Accounting Standards Review Board had limited resources and limited functions, and its part-time members met only a few times per year. One of its main functions was to review and, if thought fit, approve financial reporting standards submitted to it, thereby giving the standards legal force.

2.4 From 1993 until late 2002, the Financial Reporting Standards Board created financial reporting standards (FRS). The Accounting Standards Review Board, if it thought fit, then approved those standards for application by certain reporting entities (including most entities in the public sector) when preparing their general purpose financial reports. Therefore, setting standards for financial reporting required both boards to co-operate.

2.5 FRS took into account the nature of the different entities that would be applying the standards. That is, the Financial Reporting Standards Board took account of entities in the public sector, not-for-profit sector, and private sector when determining financial reporting requirements. Taking account of a broad range of entities meant thinking about:

- a broad range of transactions;
- the various reasons for transactions being carried out;
- a broad range of readers of financial statements; and
- the range of information those readers needed.

2.6 As well as taking account of the broad range of entities, FRS were typically written using language that was appropriate to all entities. The language made sense for the public, not-for-profit, and private sectors. For example, the term “service potential” was used in conjunction with the term “economic benefits”. The term economic benefits is generally used when referring to assets that generate net cash inflows, and therefore is relevant to the private sector. The term service potential is a broader idea that is used when referring to assets that are used to deliver goods and services in accordance with an entity's objectives. Therefore, it is more relevant to the public and not-for-profit sectors.

2.7 Creating financial reporting standards in this way meant that New Zealand financial reporting standards were widely accepted as "sector neutral". The term sector neutral was used because this type of standard took into account issues affecting all sectors and could generally be read, understood, and applied by all entities.

2.8 A sector-neutral approach to setting standards was, as far as I am aware, used only in New Zealand and Australia. In other jurisdictions, there is separation between public sector standards and private sector standards.

2.9 The general alignment of New Zealand and Australian financial reporting standards was not coincidental. One of the functions of the Accounting Standards Review Board set out in the Financial Reporting Act 1993 was to liaise with the Australian Accounting Standards Board with a view to harmonising financial reporting standards.

Deciding to adopt International Financial Reporting Standards

2.10 In June 2002, Australian authorities[1] decided that entities subject to the Australian Corporations Act 2001 should be required to comply with the financial reporting standards of the International Accounting Standards Board for periods beginning on or after 1 January 2005. That Board's standards are known as International Financial Reporting Standards (IFRS).

2.11 I understand that the Australian decision was prompted by a European decision to adopt IFRS for entities listed on European stock exchanges. The European decision to adopt IFRS was also for periods beginning on or after 1 January 2005.

2.12 Adopting IFRS was expected to improve listed entities' access to international capital markets. Improved access was expected to arise because financial statements of listed entities across different jurisdictions would be directly comparable when prepared using the same set of standards.

1 The authorities involved in the decision to adopt IFRS were the Australian Financial Reporting Council and the Australian Accounting Standards Board.

2.13 The Australian announcement raised a critical issue for New Zealand, partly because of the Accounting Standards Review Board's responsibility to liaise with the Australian Accounting Standards Board with a view to harmonising financial reporting standards between New Zealand and Australia. The issue was debated by both the Accounting Standards Review Board and the Financial Reporting Standards Board.

2.14 In October 2002, the Accounting Standards Review Board decided that "listed issuers"[2] would be required to comply with IFRS from 2007, but would be allowed to comply earlier. The Accounting Standards Review Board also committed to maintaining sector-neutral standards.

2.15 Members of the Accounting Standards Review Board together with members of the Financial Reporting Standards Board consulted with selected constituents about the announcement to adopt IFRS. I was one of those consulted.

2.16 At that time, I noted that every effort should be made to maintain sector-neutral standards. I was clear that sector-neutral standards did not mean private sector standards with addenda or boxed inserts. Rather, sector-neutral standards were ones that had regard to (and established guidance for) all entities applying them.

2.17 There were several characteristics I felt would be needed in sector-neutral standards based on IFRS. These characteristics included:

- using sector-neutral language, such as service potential, in conjunction with economic benefits;
- using illustrative examples reflecting a range of circumstances in the different sectors;
- adding or changing requirements for the public sector where IFRS either did not cover or inappropriately dealt with a matter;
- writing standards relevant only to the public sector, such as a standard dealing with social policy obligations;
- keeping relevant guidance from financial reporting standards (FRS) and statements of standard accounting practice (SSAP);
- eliminating some options in IFRS where there were no such options in FRS and SSAP; and
- keeping standards relevant to New Zealand that did not have an international equivalent.

2 Listed issuers are parties to a listing agreement with a stock exchange in New Zealand that have issued securities which are quoted on such an exchange.

2.18 Although I supported sector-neutral standards based on IFRS, I did not consider that sector-neutral standards should be sought at any cost. At the time, I noted that if sector-neutral standards could not be delivered, then it would be preferable to either:

- keep FRS and SSAP for application by public sector entities; or
- explore public sector standards based on International Public Sector Accounting Standards (IPSAS).

2.19 In December 2002, after consultation, the Accounting Standards Review Board broadened its October 2002 decision by requiring all reporting entities in the public and private sectors to apply new standards based on IFRS. Entities would be required to apply the new standards for reporting periods beginning on or after 1 January 2007. There would be an option to apply the new standards early, from reporting periods beginning on or after 1 January 2005. The option meant that entities listed in both New Zealand and Australia could apply standards based on IFRS at the same time.

2.20 Also in December 2002, the Accounting Standards Review Board reiterated that there was strong support to continue to have one set of sector-neutral standards that applied to the public, private, and not-for-profit sectors.

2.21 The decision to give entities an option to apply the new standards early meant a set of standards based on IFRS would need to be in place by the end of 2004. The set of standards to be in place by the end of 2004 was referred to as the "stable platform". That is, those standards would be the initial IFRS-based standards that could be applied from periods beginning 1 January 2005. The stable platform would be added to and changed over time as the International Accounting Standards Board created or modified standards for which the Financial Reporting Standards Board established New Zealand equivalents.

Coming up with guidelines for adapting IFRS

2.22 After the Accounting Standards Review Board decision in 2002, the Financial Reporting Standards Board began work on the new set of standards. The Financial Reporting Standards Board needed to review all the International Accounting Standards Board's standards to find out what changes were needed for reporting entities in the public sector and not-for-profit sector.

2.23 In the first half of 2003, the Financial Reporting Standards Board worked on how to adapt IFRS for entities in the public sector and not-for-profit sector. Staff from my Office were involved in that task, and they kept me informed of progress.

2.24 During that time, it became clear that New Zealand would not be able to both:

- produce sector-neutral financial reporting standards based on IFRS for application by all entities; and
- have profit-oriented entities state that they complied with IFRS.

2.25 The reason it would not be possible to have both sector-neutral standards and the stating of compliance with IFRS was because of limitations imposed by the International Accounting Standards Board. The Board was clear about changes that could and could not be made to IFRS if entities applying the changed standards wanted to state their compliance with IFRS.

2.26 Changing to sector-neutral words and adding or changing requirements, other than additional disclosures, were changes that were not acceptable to the International Accounting Standards Board. The Board decided that such changes would affect the integrity of IFRS and potentially affect the way a standard was interpreted. This concern about compromising the integrity of IFRS later led to the Financial Reporting Standards Board's reluctance to make changes to IFRS when establishing New Zealand equivalents to IFRS (NZ IFRS).

2.27 Given that the main reason for adopting IFRS was that profit-oriented entities would be able to state that they complied with IFRS, sector-neutral standards were abandoned. Instead, the Financial Reporting Standards Board decided to maintain a single set of financial reporting standards, by adding some material to IFRS specifically for public benefit entities in the public and not-for-profit sectors.

2.28 Although described as a single set of standards, it was basically two sets of standards packaged together: one set for profit-oriented entities and the other set for public benefit entities. It was convenient for these sets to be packaged as one because they were substantially the same, with little additional material for public benefit entities.

2.29 By mid-2003, I was concerned that the way IFRS were being adapted to NZ IFRS meant public sector issues would not be given adequate thought. Because of these concerns, I wrote to the Accounting Standards Review Board, the body ultimately responsible for approving NZ IFRS.

2.30 I made it clear to the Accounting Standards Review Board that support from the public sector for NZ IFRS might not be sustained if the standards did not adequately cater for the public sector. I was also clear that the primary objective of those standards had to be providing quality reporting for people using financial statements.

2.31 The Accounting Standards Review Board responded to my concerns by agreeing to update its Release 6, which set out its procedures for establishing financial reporting standards. The update needed to deal with the adoption of IFRS and set clear expectations for the adaptation of IFRS for issue as NZ IFRS. Work was carried out from mid-2003 on the Accounting Standards Review Board's expectations for how IFRS could be adapted for issue as NZ IFRS. This culminated in the Accounting Standards Review Board publishing its Release 8 in May 2004,[3] which updated Release 6.

2.32 Release 8 included several guidelines that are relevant to the public sector for adapting IFRS for issue as NZ IFRS. The effect of those guidelines for many entities in the public sector included:

- disclosure requirements could be added or reduced;
- recognition and measurement requirements could be amended;
- guidance materials could be added; and
- options could be eliminated.

2.33 Those guidelines were to be applied where there were features unique to public benefit entities; that is, most entities in the public sector and entities in the not-for-profit sector.

2.34 The guidelines addressed many of the characteristics I felt needed to be addressed at that time. However, I was disappointed that sector-neutral financial reporting standards could not be accommodated. Although disappointed, I was aware that the focus during this period was very much on adapting IFRS to NZ IFRS before 2005.

Adapting IFRS to NZ IFRS before 2005

2.35 Much of the adaptation of IFRS to NZ IFRS happened at the same time as the Accounting Standards Review Board was preparing its Release 8. The Financial Reporting Standards Board was kept informed about the guidelines in Release 8 as they were being worked on. Therefore, the Financial Reporting Standards Board was able to propose changes between IFRS and NZ IFRS during 2003 and 2004 that would be consistent with the guidelines, once they were published.

2.36 Part of the adaptation process required the Financial Reporting Standards Board to distinguish profit-oriented entities that had to apply IFRS from other entities for which modification to IFRS could be made. The term "public benefit entities" was established to encompass all reporting entities that were not profit-oriented entities.

3 Releases 6 and 8 were about the role of the Accounting Standards Review Board and the nature of approved financial reporting standards.

2.37 The Financial Reporting Standards Board established a conversion working group that worked through much of the detail of adapting IFRS to NZ IFRS. That group proposed a considerable number of changes to IFRS for public benefit entities and some changes (predominantly adding disclosure requirements) for all entities. The Financial Reporting Standards Board accepted many of the working group's changes to IFRS as it established the NZ IFRS stable platform.

2.38 The pace at which IFRS were adapted to NZ IFRS was phenomenal. At that time, IFRS consisted of more than 30 reporting standards and more than 10 interpretations of standards. All of those documents had to be reviewed, mostly by the conversion working group, and changes proposed to the Financial Reporting Standards Board. The proposed NZ IFRS were then issued for comment during a period of just over 12 months.

2.39 My Office commented to the Financial Reporting Standards Board on some of the proposed new financial reporting standards. However, the large number of documents issued over such a short time meant that we did not have the capacity to submit on all matters. Nor did we have time to give detailed consideration to all of the changes that were being proposed. That, and the overall pace of change, concerned me.

2.40 Several other issues emerged during the adaptation process. I became increasingly concerned at what I saw as a reluctance to make changes to IFRS. For example, there were several areas where I thought guidance for public benefit entities was warranted. However, in my view, the Financial Reporting Standards Board was reluctant to add guidance for public benefit entities because of a concern that guidance could unduly influence profit-oriented entities. Such concern seemed misguided given that:

- guidance could have been clearly labelled as relating only to public benefit entities; and
- the Financial Reporting Standards Board had acknowledged that changes would be required.[4]

2.41 I was also concerned that very few public sector entities were commenting on proposed financial reporting standards. In my view, the lack of comment was because there were too many proposals and a general sense that IFRS had been adopted with little room to influence any change, even for public benefit entities. As a result, entities focused on training their staff about NZ IFRS so they could implement them.

4 In paragraph 5 of the appendix to the New Zealand Equivalent to the IASB Framework for the Preparation and Presentation of Financial Statements (the NZ Framework), the Financial Reporting Standards Board explained its rationale for making changes to the International Accounting Standards Board Framework and IFRS. It noted that many "issues are not unique to public benefit entities but they may require more emphasis and consideration for the accounting standards to be relevant to public benefit entities and to ensure that the desired level of consistency in reporting by those entities is achieved".

2.42 Another concern was that the adoption of IFRS was dominating the use of standard setting resources. There were other important public sector reporting issues that were not receiving attention. In my view, the most important of these was the reporting of non-financial performance information. I acknowledge the challenges involved in setting standards for non-financial performance information, given that there has been little progress anywhere in the world on this matter.

2.43 Finally, I was concerned that the membership of the Financial Reporting Standards Board had not been changed to reflect the new approach to setting financial reporting standards. Given that IFRS applied solely to profit-oriented entities, a crucial role for standard setting was to establish standards that would be suitable for public benefit entities by making relevant and appropriate changes and adding guidance. In my view, the membership of the Financial Reporting Standards Board should have better reflected the role of the Board in the new environment.

2.44 Nevertheless, the Financial Reporting Standards Board completed the adaptation process and provided the initial set of NZ IFRS to the Accounting Standards Review Board before the end of 2004. The Accounting Standards Review Board approved that initial set in November 2004. This approval meant there was a stable platform in place for entities that chose to apply NZ IFRS from periods beginning 1 January 2005. The stable platform represented a significant milestone and, notwithstanding my concerns noted above, generally reflected well on those involved in the adaptation to NZ IFRS.

Creating financial reporting standards to supplement NZ IFRS

2.45 Since the initial stable platform of NZ IFRS was established in late 2004, there has continued to be considerable activity in setting financial reporting standards. Important areas of standard setting that were not covered by IFRS included setting standards consistent with NZ IFRS on prospective financial statements and summary financial statements.

2.46 Before NZ IFRS were introduced, standards on prospective financial information and summary financial statements had been an integral part of the previous set of financial reporting standards.

2.47 The stable platform of NZ IFRS that the Financial Reporting Standards Board established did not contain standards dealing with prospective financial statements or summary financial statements. There were no standards on these matters because IFRS, on which the stable platform was based, did not deal with those matters.

2.48 To the credit of the Financial Reporting Standards Board, it decided that New Zealand should not abandon the standards dealing with prospective financial statements and summary financial statements. Standards in both these areas are important to a considerable number of entities, including entities in the public sector. Many public sector entities have statutory responsibilities to publish forecast or summary financial statements, or both.

2.49 The Financial Reporting Standards Board decided to rewrite its standard on prospective financial information and to revise its standard on summary financial statements. My staff were involved in the changes to both those standards.

2.50 My staff involved in rewriting the standard on prospective financial statements told me that the overall aim was to produce a high-quality standard. The standard had to work for all entities, whether profit-oriented or public benefit. From an audit perspective, we have found the standard helpful, given its principles-based focus and proper consideration of issues affecting the public sector.

2.51 In my view, the standard on prospective financial statements is one of the better standards for the public sector since the adoption of NZ IFRS because it was designed in New Zealand with all sectors in mind (that is, it could be properly described as sector neutral).

Setting up a public benefit entity working group

2.52 In June 2005, the Financial Reporting Standards Board agreed to set up a public benefit entity working group to look at public benefit entity issues and make recommendations to the Financial Reporting Standards Board. I saw the setting up of this working group as a positive step and I was pleased that two members of my staff were involved.

2.53 My staff wrote to the chairman of that working group soon after it was established in late 2005. The letter set out what we saw as important public sector issues we would like the working group to address. We attempted to prioritise the issues and we were clear that the list was not intended to be an end in itself.

2.54 However, I am disappointed that most of the issues we raised with the public benefit entity working group have not been addressed in the past 3½ years. Many of the issues we raised related to NZ IFRS and a few were significant public sector issues in their own right that needed addressing.

2.55 I am aware that the public benefit entity working group invested a lot of its time and effort since 2005 in producing a financial reporting guide for not-for-profit entities. That guide was published in August 2007. Also, the working group prepared supporting material such as model financial statements and a financial statement disclosure checklist. I commend the working group for producing helpful guidance aimed at not-for-profit charitable organisations and clubs.

2.56 After the not-for-profit financial reporting guide was published, it was decided to defer the mandatory adoption of NZ IFRS for many of the entities the guide was aimed at. That decision was somewhat unfortunate for the working group, given all their time and effort.

2.57 The public benefit entity working group's focus on the not-for-profit financial reporting guide meant little progress had been made on the public sector issues my staff had raised with the chairman of the working group. Also, perhaps not surprisingly, other public sector issues have since arisen that, in my view, need addressing.

2.58 Unfortunately, despite its initial promise, the public benefit entity working group has had little real effect in getting relevant and appropriate changes made to NZ IFRS for public benefit entities, particularly those in the public sector.

Deciding to defer mandatory adoption of NZ IFRS for some entities

2.59 In the first half of 2007, the International Accounting Standards Board issued for comment a proposal for international financial reporting standards for small- and medium-sized entities. This proposal was for a self-contained set of financial reporting standards relevant to smaller profit-oriented entities. The Financial Reporting Standards Board prepared a discussion paper about the proposal and sought the views of people who were interested in financial reporting standards for smaller entities.

2.60 That proposal led the Financial Reporting Standards Board to hold consultation meetings throughout the country between April and July 2007. The ostensible purpose of the meetings was to hear people's views about the proposal for standards for small- and medium-sized entities. Instead, the meetings elicited a clear message about NZ IFRS.

2.61 The clear message was that NZ IFRS were not needed for many entities, particularly small- and medium-sized companies and similar entities in the private sector. I am aware that this message was brought to the attention of the Accounting Standards Review Board and government officials.

2.62 The outcome of those meetings probably contributed to a decision by the Government to review the financial reporting requirements applying to small- and medium-sized companies under the Financial Reporting Act 1993 (see paragraphs 2.67–2.72).

2.63 The announcement of the review led the Accounting Standards Review Board to delay the mandatory adoption of NZ IFRS for certain small entities. This decision was set out in its Release 9, published in September 2007, and applied to companies that were:

- not an issuer as defined by the Financial Reporting Act 1993 (the Act), in either the current or preceding accounting period;
- not required by section 19 of the Act to file financial statements with the Registrar of Companies; and
- not large, as defined by section 19A of the Act.

2.64 A primary reason cited for the delay related to a possible outcome of the review – namely, that many small- and medium-sized companies that currently must prepare financial statements in accordance with generally accepted accounting practice solely because they are required to by legislation, might have that requirement removed. The removal of the requirement would mean that the costs associated with changing to NZ IFRS would have been wasted.

2.65 In addition to the delay announced by the Accounting Standards Review Board, the Financial Reporting Standards Board decided it would delay the mandatory adoption of NZ IFRS for some other entities that prepared general purpose financial statements but were not subject to the Act. Those other entities were entities that were not publicly accountable and were not large as defined in the Framework for Differential Reporting.[5] However, neither of these delays had much effect on the public sector because most public sector entities were not able to take advantage of either of them.

2.66 The result of the delays is that the only entities required to apply NZ IFRS are issuers[6] and most public sector entities. Of these, I expect there are more public than private sector entities. In my view, the large number of public sector entities using NZ IFRS reinforces the case for NZ IFRS to incorporate all the relevant and appropriate changes to ensure that they can be readily applied by the public sector.

5 The Framework for Differential Reporting is part of generally accepted accounting practice. The Framework sets out the concessions from NZ IFRS that are available to entities that qualify to apply the Framework.

6 Issuers are defined in section 4 of the Financial Reporting Act 1993 and include entities listed on a stock exchange in New Zealand, registered banks, life insurance companies, and unit trusts. Section 6 clarifies the definition of issuers for entities in the public sector.

Reviewing the financial reporting framework

2.67 The Ministry of Economic Development (MED) has been reviewing the financial reporting framework. The review is expected to result in the release of a discussion paper in the second half of 2009. Also, the discussion paper is expected to be accompanied by an Accounting Standards Review Board paper about the broad nature of reporting within the various tiers in the framework.

2.68 As a precursor to the discussion paper, the MED has carried out a "greenfields" review of the financial reporting framework (that is, the MED has thought about its recommendations assuming that there were no existing financial reporting requirements).

2.69 The MED consulted with staff in my Office in late 2008, seeking our comments about a financial reporting framework for reporting entities in the public sector. We noted that our generally held view is that all public sector entities have some level of accountability to Parliament and the public. In order to be accountable, we noted that public sector entities should be required to provide Parliament and the public with financial and, where appropriate, non-financial information that meets their information needs.

2.70 We were clear in our comments that the information that public sector entities were required to report should take account of the needs of those people using the information. We were also clear that the information required should be broadly proportional to the size, significance, complexity, and resources of each reporting entity. In that regard, we considered it necessary to have a framework that included different levels of reporting for different types of entity. We noted that the framework should encompass more than the current differential reporting regime.

2.71 We also expressed our view that the review of the financial reporting framework provided an ideal opportunity to reconsider the basis for financial reporting for all entities, other than:

- listed entities;
- those entities accessing international capital markets; and
- other profit-oriented entities that wish to state their compliance with IFRS.

2.72 We noted that all other entities, including nearly all of the public sector, would be better served by creating financial reporting standards that are more appropriate to those entities and to the people using those entities' financial statements.

Reviewing the guidelines for setting financial reporting standards

2.73 In a letter to me in late 2007, the Accounting Standards Review Board noted the desirability of reviewing the guidelines for setting financial reporting standards as set out in its Release 8.[7]

2.74 I thought that a review of the guidelines was imperative and that urgent changes should be made to the framework for reporting by public benefit entities. In further correspondence with the Accounting Standards Review Board, I noted that the goal of the new guidelines needed to be high-quality financial reporting standards. Those standards also needed to provide the people who use financial statements with the information they needed.

2.75 The Accounting Standards Review Board decided to consult with representatives from selected organisations that had an interest in financial reporting by public benefit entities. The consultation was about the future of standard setting for public benefit entities to assist the Accounting Standards Review Board with the review of the guidelines.

2.76 Consultation meetings took place in mid-2008 and I was one of those consulted. Before the meeting I was provided with a confidential paper. The paper explained the background to the review of the process for setting financial reporting standards for public benefit entities and outlined some possible alternative approaches to that process.

2.77 In my view, the confidential paper that formed the basis of the consultation was not balanced because it favoured minimising changes to IFRS when establishing NZ IFRS. I gave serious thought to not taking part in the consultation. Nevertheless, I decided it was better to take part, and I conveyed my concerns during the meeting and subsequently in writing.

2.78 During the consultation, I made it clear once again where I thought the focus should be for setting financial reporting standards for public benefit entities; that is, it should be on setting high-quality standards that meet the information needs of people using the financial statements of public benefit entities. The focus did not need to be dictated by a rigid approach designed to minimise changes between IFRS and NZ IFRS.

2.79 Since that consultation, the Accounting Standards Review Board has issued for public comment a proposal to revise Release 8. Likewise, the Financial Reporting Standards Board has issued for public comment a document that outlines their

7 The desirability for such a review was raised at a time when I was corresponding with the Accounting Standards Review Board on another matter. That correspondence was about concerns I had with a financial reporting standard the Accounting Standards Review Board had approved in July 2007, one that required compulsory capitalisation of borrowing costs. I elaborate on those concerns in Part 4, starting at paragraph 4.84.

proposed process for modifying, or introducing additional requirements to, IFRS for public benefit entities. I have had the opportunity to review these documents.

2.80 The Accounting Standards Review Board's proposed revisions to Release 8 contain some changes to how financial reporting standards based on IFRS would be established. Those changes make reference to the work of the International Public Sector Accounting Standards Board. The revised procedures are, in the main, reasonable if it is accepted that IFRS are the appropriate base for those standards. Nonetheless, even if one does accept IFRS as the appropriate base, the procedures are high level and, in my view, open to interpretation.

2.81 I consider that the Financial Reporting Standards Board's document on the proposed process for modifying or introducing additional requirements to IFRS for public benefit entities is the more important of the two documents because it contains the criteria for when IFRS will be modified for public benefit entities.

2.82 Based on what the Financial Reporting Standards Board has issued for comment, in my view it is unlikely there will be enough change to the way standards are set to alleviate my concerns. There continues to be undue focus on minimising changes between IFRS and NZ IFRS rather than on delivering high-quality financial reporting standards for public benefit entities.

Assessing the financial reporting standards for the public sector

2.83 I decided it was important for this discussion paper to assess the effects of the standard setting that has taken place in New Zealand in recent years. Therefore, in April 2009, my staff carried out an assessment of the financial reporting standards in place for public benefit entities.

2.84 Appendix 1 contains a high-level comparison of NZ IFRS with New Zealand's financial reporting standards that applied before NZ IFRS. The comparison is based on the standards in place under NZ IFRS as at 31 March 2009. Appendix 1 includes brief comments that reflect the judgements my staff and I have made about what has been gained or lost from adopting NZ IFRS.

2.85 One of the first and most obvious points to note is that NZ IFRS cover more topics than previous standards. For example, within NZ IFRS there are standards that cover accounting for revenue, employee benefits, and financial instruments. There were no standards covering these topics in the previous set of standards.

2.86 Having a set of standards that covers a broader range of topics is desirable. At a high level, greater coverage of topics should lead to greater consistency of reporting of transactions in general purpose financial reports of public sector entities. Greater consistency should help those that use financial reports, particularly those that use them with some frequency.

2.87 However, a detailed look at the comparison shows that many of the gains in the number of topics covered by NZ IFRS have been undermined by concerns about the quality of standards for public benefit entities. These concerns arise because:

- there is less guidance on the application of requirements to the public sector (for example, guidance on property, plant, and equipment subsequent expenditure, components, and use of indices in a depreciated replacement cost valuation);
- there are standards that do not address public sector aspects that could reasonably be expected (for example, how a public sector entity should account for a suspensory loan that is documented as a liability but, in substance, is equity); and
- there are some questionable disclosures required, particularly where the costs associated with many disclosures exceed the benefits of making the disclosures (for example, disclosure of an entity's objectives, policies, and processes for managing capital even though most public benefit entities do not have capital to manage).

Concluding comments

2.88 For the past 6½ years, New Zealand's standard setting agenda has all but been determined by the International Accounting Standards Board. Setting the agenda this way has not helped public benefit entities because the International Accounting Standards Board has no mandate to consider public benefit entities.

2.89 Also, the pace at which the International Accounting Standards Board has issued new pronouncements has meant the Financial Reporting Standards Board has been unable to deal adequately with issues for public benefit entities. It is as if public benefit entities have been forgotten in the rush to issue International Accounting Standards Board pronouncements to ensure that profit-oriented entities in New Zealand can assert compliance with IFRS. The result has been generally poor standard setting for public benefit entities.

2.90 When I reflect on NZ IFRS for public benefit entities compared with previous financial reporting standards, I am disappointed. Since the decision to adopt IFRS as the basis for New Zealand's financial reporting standards, 6½ years have elapsed. I do not see 6½ years' worth of progress in public sector reporting. In my view, it is unfortunate that the concerns described above have undermined many of the gains.

2.91 I wonder where financial and non-financial reporting in the public sector would be today, had the Accounting Standards Review Board decided in 2002 that:

- only listed issuers would be required to apply IFRS; and
- New Zealand standards would be retained and improved for all other reporting entities.

Part 3
Setting standards internationally

3.1 In this Part, I comment on setting financial reporting standards by the two main international boards that set such standards: the International Accounting Standards Board, and the International Public Sector Accounting Standards Board. These comments show that there is a set of international financial reporting standards for use by public sector entities around the world.

Standard setting activities of the International Accounting Standards Board

3.2 The International Accounting Standards Board is an independent international standard-setting board established in 2001. Members of the Board are appointed and overseen by trustees who are accountable to capital market authorities and are expected to act in the public interest. The Board's objective is to provide the world's international capital markets with a common language for financial reporting.

3.3 Until 2001, there was an International Accounting Standards Committee that had created international accounting standards and international interpretations of those standards for application by profit-oriented entities. Those standards and interpretations were largely a product of international consensus. As a result, the requirements of the standards and interpretations often contained options for recognising, measuring, or presenting transactions.

3.4 The International Accounting Standards Board decided to adopt the standards and interpretations of the International Accounting Standards Committee as a basis for the standards that it would put in place. In my view, that decision was made for expediency rather than because the International Accounting Standards Board members necessarily agreed with the full content of the standards and interpretations they adopted from the International Accounting Standards Committee. I am aware, for instance, of several occasions when the International Accounting Standards Board chairman has made less than favourable public comments about several International Accounting Standards Committee standards adopted by the International Accounting Standards Board.

3.5 Nevertheless, the decision to adopt the International Accounting Standards Committee's standards and interpretations meant the International Accounting Standards Board had a suite of 31 standards and 11 interpretations soon after it was established.

3.6 Soon after the International Accounting Standards Board was established, the European Union passed a regulation to adopt IFRS for listed entities from 2005.

The European decision was followed by decisions in Australia and New Zealand in 2002 to adopt IFRS as the basis for financial reporting standards for all entities (see Part 2).

3.7 The pace of adoption of IFRS for listed entities by other countries has been phenomenal. There are now more than 100 countries that either require or permit the use of IFRS for listed entities (although very few of these countries adopted IFRS, or used IFRS as a base, for public benefit entities).

3.8 The early decision by the European Union to adopt IFRS from 2005 for listed entities put some pressure on the International Accounting Standards Board to have in place a reasonably stable set of standards by 2005 to ease the adoption of IFRS. In the lead up to 2005, the International Accounting Standards Board added five standards and one interpretation to the suite of standards and interpretations adopted from the International Accounting Standards Committee. Standard setting work continued after getting these standards and interpretations in place. However, the International Accounting Standards Board decided that any further standards or interpretations would not apply until 2006 or beyond.

3.9 In the first full year of the International Accounting Standards Board's operation, there was a joint meeting with the United States Financial Accounting Standards Board. I understand the meeting took place because the International Accounting Standards Board wanted IFRS to have international credibility. International Accounting Standards Board members were aware that the United States was a very influential country in international capital markets.

3.10 At a joint meeting of the International Accounting Standards Board and Financial Accounting Standards Board, both Boards acknowledged they were committed to creating high-quality compatible accounting standards for cross-border financial reporting. The Boards would use their best efforts to:

- make their existing financial reporting standards fully compatible as soon as practicable; and
- co-ordinate their respective future work programmes to ensure that, once achieved, compatibility would be maintained.

3.11 Six to seven years later, the convergence of United States financial accounting standards and IFRS is still a priority for the International Accounting Standards Board. That Board and the Financial Accounting Standards Board continue to work on converging their standards. There needs to be enough convergence to enable non-United States companies registered in the United States to use IFRS-based financial information without the need to reconcile that information to information based on United States financial accounting standards. Further to that, I understand the United States Securities and Exchange Commission is giving thought to whether and when it might permit United States companies to adopt IFRS for financial reporting purposes.

3.12 The International Accounting Standards Board has produced many standards, interpretations, changes to standards and interpretations, and discussion papers. I know that there have been more than 50 such pronouncements issued by the International Accounting Standards Board in the past 4½ years. That volume of material is difficult enough for large multinational companies, their stakeholders, and other interested parties to engage with, let alone others.

3.13 As is to be expected, the International Accounting Standards Board's standards and interpretations are focused largely on companies operating in the world's capital markets, including standards and interpretations for:

- the types of transactions those companies carry out; and
- the information used by people interested in those companies (for example, investors, analysts, and regulators).

3.14 Some of the significant areas of standard setting work carried out by the International Accounting Standards Board in recent years include:

- new standards on disclosing financial instruments information, and reporting disaggregated financial information;
- revised standards on accounting for business combinations when one entity acquires another entity, on capitalising borrowing costs when constructing assets, and on recognising and measuring financial instruments;
- a possible new standard (later this year) on recognising and measuring liabilities; and
- discussion papers about presenting financial statements, and measuring assets and liabilities at fair value.

3.15 Also, for the past few years, the International Accounting Standards Board (in conjunction with the Financial Accounting Standards Board) has been putting a lot of effort into creating a new conceptual framework for profit-oriented entities. Because this is a large project, it has been split into eight distinct phases. Each phase is expected to result in a discussion paper and a draft proposal before any proposal is finalised.

3.16 At the end of March 2009, two discussion papers and one draft proposal had been issued for comment but no proposals had been finalised and issued.

3.17 The proposals for the framework seem to be built on the following main purpose for financial reporting – that of providing financial information about an entity that can be used by capital providers (current and potential equity investors, lenders, and other creditors) to make economic decisions. There is also a strong emphasis on assessing cashflow prospects, including the ability to generate cashflows and reinvest in operations.

3.18 The seventh phase in the International Accounting Standards Board's project to create a conceptual framework will consider how the framework could be applied to not-for-profit entities. Given the positioning of this phase within the context of the overall project, I have doubts about what the phase will achieve. I also have doubts about whether the phase will be carried out at all, given that not-for-profit entities are currently outside the International Accounting Standards Board's overall objective (see paragraph 3.2).

3.19 In my view, the direction being taken by the conceptual framework project does not bode well for New Zealand public benefit entities. I believe that as long as IFRS remain the basis for financial reporting standards for public benefit entities, the International Accounting Standards Board's conceptual framework will be the basis for any new New Zealand equivalent framework. This conceptual framework will have a narrow focus that will make it difficult to adapt in a meaningful way for most New Zealand public sector entities. I elaborate on this concern in Part 4.

3.20 In summary:

- the International Accounting Standards Board is acknowledged as an international standard setter for entities operating in the capital markets;
- already more than 100 countries have adopted IFRS (however, in nearly all of these countries, IFRS are being adopted by listed entities only); and
- increasingly, the International Accounting Standards Board is narrowing its focus in a way that will make adaptation for public benefit entities more difficult.

Standard setting activities of the International Public Sector Accounting Standards Board

3.21 The International Accounting Standards Board is not the only international board setting financial reporting standards. The International Public Sector Accounting Standards Board (also known as the IPSASB) is a part-time international standard setting board within the International Federation of Accountants (the global organisation for the accountancy profession).[1] One of my staff represented New Zealand on the International Public Sector Accounting Standards Board from 2004 to 2008. The objective of the International Public Sector Accounting Standards Board is to serve the public interest by creating high-quality financial reporting standards for use by public sector entities around the world.

1 The International Public Sector Accounting Standards Board is not currently subject to independent oversight. It is possible that the Public Interest Oversight Board within the International Federation of Accountants could provide independent oversight sometime in the future.

3.22 The main focus of the International Public Sector Accounting Standards Board up to 2002 was establishing a core set of financial reporting standards for the public sector. The core set of standards was largely based on IFRS. Importantly, however, IFRS were modified in ways that made the standards more easily applied in the public sector.

3.23 In my view, putting in place the core set of standards helped to establish the credibility of the International Public Sector Accounting Standards Board as an international standard setter.

3.24 From 2002, the International Public Sector Accounting Standards Board began to work on some of the more difficult areas of public sector financial reporting that differentiate the public sector from the private sector. Public sector standards have since been established in several areas including:

- reporting historical results against budgeted information;
- accounting for impairment of assets that are not designed to generate a commercial return; and
- accounting for revenue that is not derived through a normal commercial transaction.

3.25 Writing standards about difficult public sector issues has taken considerably more time than the core set because of the work needed to properly address the public sector perspective.

3.26 More recently, in 2007, the International Public Sector Accounting Standards Board reconsidered its strategic direction. Four strategic themes emerged. These themes were:

- creating a public sector conceptual framework;
- working on public sector-specific projects;
- converging International Public Sector Accounting Standards (IPSAS) with IFRS; and
- promoting and communicating IPSAS.

3.27 The International Public Sector Accounting Standards Board gives equal weight to each of these strategic themes. That equal weighting is a change from the International Public Sector Accounting Standards Board's focus, until 2002, on converging IPSAS with IFRS.

3.28 A significant focus of the International Public Sector Accounting Standards Board's work since 2007 has been creating a conceptual framework for reporting by public sector entities. The International Public Sector Accounting Standards Board decided that this work would not be part of its convergence with the work of the

International Accounting Standards Board. That is, the International Public Sector Accounting Standards Board's conceptual framework project is separate from, and not designed to adapt, the conceptual framework of the International Accounting Standards Board (as discussed in paragraphs 3.15–3.19).

3.29 The International Public Sector Accounting Standards Board's conceptual framework is focused on the public sector and will need to recognise the real differences between the public and private sectors. The framework will also need to make explicit the concepts, definitions, and principles that will underpin public sector reporting in future. The Board's approach to the conceptual framework could have significant implications for the convergence of IPSAS with IFRS.

3.30 Work has also continued on core public sector areas such as social policy obligations (for example, the obligations of governments in relation to pensions) and long-term fiscal sustainability. In 2008, the International Public Sector Accounting Standards Board approved a project on long-term fiscal sustainability reporting.

3.31 There is an implicit recognition by the International Public Sector Accounting Standards Board in taking on a project about long-term fiscal sustainability reporting that traditional historical financial statements (such as income statement, statement of cashflows, and balance sheet) have their limitations in providing useful information. I agree that traditional financial statements do not work particularly well for some of the difficult public sector accounting and accountability issues.

3.32 New Zealand already has various forms of long-term fiscal sustainability reporting. For instance, the Crown has a report on its long-term fiscal position for at least 40 years ahead. In the local government sector, long-term council community plans include forecasts for at least 10 years.

3.33 Long-term fiscal sustainability reporting is gathering momentum around the world as the affordability of government programmes comes more sharply into focus. Increasingly, this is the sort of information that people need to see in order to hold governments and public sector entities to account, in addition to the information in the traditional financial statements.

3.34 Although a lot of the International Public Sector Accounting Standards Board's attention is focused on difficult public sector accounting issues, convergence with IFRS remains an important part of the Board's work plan. The convergence of IPSAS with IFRS is not yet complete. Work is under way on a range of topics, such as financial instruments, intangible assets, and entity combinations. For these topics, IFRS continue to be used as the starting point for IPSAS.

3.35 The Board's approach to convergence is straightforward in that, where appropriate, IFRS are adapted to suit public sector circumstances and transactions. The International Public Sector Accounting Standards Board has established what it calls "rules of the road". The rules (better described as guidelines, as they are not applied rigidly) help the International Public Sector Accounting Standards Board to decide when it is appropriate to change IFRS to produce high-quality IPSAS for application by the public sector.

3.36 The International Public Sector Accounting Standards Board's approach includes a set of criteria applied on a case-by-case basis. These criteria for amending IFRS include things such as "where objectives of public sector financial reporting will not be met", and "where the cost of applying the IFRS (without change) would exceed the benefit".

3.37 It is interesting to contrast the International Public Sector Accounting Standards Board's approach to IFRS convergence with the approach being taken in New Zealand. As noted in Part 2, the approach in New Zealand, particularly since the establishment of the stable platform of NZ IFRS in late 2004, has been to make minimal change to IFRS. In my view, the International Public Sector Accounting Standards Board's approach is a more neutral approach and generally results in more changes being made to IFRS.

3.38 During the next few years, the International Public Sector Accounting Standards Board will create further standards and guidance to deal with issues not addressed in the current financial reporting standards. During that period, I expect there will be an increasing trend around the world for countries to adopt (or adapt) the International Public Sector Accounting Standards Board's standards for use by governments and other public sector entities.

Concluding comments

3.39 In my view, those responsible for setting public sector financial reporting standards in New Zealand need to make better use of the work of the International Public Sector Accounting Standards Board. That work should help shape New Zealand's public sector financial reporting standards.

3.40 The relevance of the International Public Sector Accounting Standards Board to New Zealand is only likely to increase as it deals with issues not adequately dealt with in IFRS (given that the focus of the International Accounting Standards Board is on large profit-oriented entities accessing capital markets).

Part 4
My concerns about financial reporting standards for the public sector

4.1 I have been concerned for some time about the effects of IFRS on the setting of financial reporting standards in New Zealand, especially as it affects the public sector. In my view, too much focus on the process for standard setting has overtaken what should be the aim of standard setting. The aim should be high-quality standards designed to produce general purpose financial reports that are understandable and can be used to properly hold public sector entities to account.

4.2 In this Part, I comment on the role of general purpose financial reports, set out my general and specific concerns about the suitability of NZ IFRS for the public sector, and raise questions about the suitability of NZ IFRS in the future.

The role of general purpose financial reports

4.3 Many people using financial and non-financial reports are not in a position to demand information that is designed specifically for their needs. However, although specific information needs cannot be met, there are typically common information needs that arise for many different people about the resources of an entity and how those resources have been used. General purpose financial reports are reports that contain financial and non-financial information that is designed to meet the common information needs of a wide range of people.

4.4 Financial reporting standards govern how general purpose financial reports are prepared. The people who use general purpose financial reports rely on the standard setter to establish reporting requirements that are relevant to the variety of entities covered by the standards. Setting standards relevant to different types of entities requires a good appreciation of the range of information needs of people using different entities' financial statements.

4.5 In my view, the information needs of people who use general purpose financial reports in the public sector are quite different from those in the private sector. In the public sector, the primary objective of general purpose financial reporting is to provide information to ensure that entities are able to meet their accountability obligations to Parliament and the public. Entities must account, and must be seen to account, for their use and stewardship of public resources in the delivery of goods and services to the community.

4.6 In my view, information in general purpose financial reports of public sector entities should have at least the following important attributes:

- the performance of the entity can be clearly understood in the context of what the entity is trying to achieve;

- the financial performance of the entity makes sense when related to its non-financial performance;
- the entity's performance can be readily compared with the plans of the entity at the start of the reporting period;
- the stewardship of the entity can be readily assessed by reference to the entity's balance sheet and supporting notes; and
- the entity's long-term sustainability can be assessed.

4.7 Implicit in ensuring that information in public sector entities' general purpose financial reports is useful to people is an acknowledgement that those reports do have limitations. In other words, general purpose financial reports cannot be expected to meet all the information needs of everyone. Rather, a sensible balance needs to be struck between not overloading people with information but at the same time providing important information with which entities can meet their accountability to the public.

4.8 I realise it is difficult to establish exactly what information should or should not be in general purpose financial reports for public sector entities. I have some ideas about the sorts of information people need in order to hold public sector entities to account. Many of my views expressed in this discussion paper will, I hope, provide some insights into the sort of information I consider is needed. However, I do not have all the answers.

4.9 As noted in paragraph 4.4, to set relevant and appropriate financial reporting standards requires a clear understanding of the needs of people who use public sector entities' general purpose financial reports. I do not think there is a widely accepted clear understanding in New Zealand. In my view, more work needs to be done on establishing that clear understanding, as well as getting general consensus about what that kind of understanding entails.

4.10 I anticipate that, if done well, the International Public Sector Accounting Standard Board's work on a public sector conceptual framework could help shape the information that would be included in public sector entities' general purpose financial reports. However, this is unlikely to provide all the answers for New Zealand.

General concerns about the suitability of NZ IFRS for the public sector

4.11 In Part 2, I expressed concerns about the process for adapting IFRS to NZ IFRS. Further to those concerns, I have some general concerns about the suitability of NZ IFRS for the public sector.

4.12 These general concerns can be grouped into two broad categories:

- the complexity of the requirements in NZ IFRS for all reporting entities in the public sector, particularly smaller entities; and
- the difficulty associated with applying many of the requirements in NZ IFRS for public benefit entities.

4.13 In my view, NZ IFRS have introduced a new and unnecessary level of complexity to general purpose financial reporting. As a result, many public sector entities now need external assistance to prepare their financial reports. Also, anecdotally, members of governing bodies and other people who use financial statements are finding it increasingly difficult to understand the information.

4.14 Increasing complexity is now evident to varying degrees in all aspects of financial reporting (that is, recognition, measurement, presentation, and disclosure). In my opinion, based on proposals currently being worked on and those that are planned, complexity is only likely to increase.

4.15 In my view, the process for setting standards is not focused enough on assessing the costs and benefits for different types of entities. Generally, a "one size fits all" approach is being taken to setting standards. The approach appears to be "if large companies have to do it, all entities can do it".

4.16 The differential reporting regime within generally accepted accounting practice is designed to ease the compliance burden on smaller reporting entities. Although this has helped financial reporting by smaller public sector entities, in my view the current differential reporting concessions do not go far enough. The concessions do not make a big enough difference between full compliance with generally accepted accounting practice and compliance with the differential reporting regime.

4.17 In my view, smaller entities need further concessions regarding recognition and measurement requirements, as well as presentation and disclosure.

4.18 For accountability to be properly served in the public sector, general purpose financial reports need to be understandable for a wide range of people. Reports that are not understandable undermine public sector accountability.

4.19 IFRS have been built on several fundamental premises that, mainly, do not apply to public benefit entities in New Zealand. The premises are that:

- entities have an overriding profit-seeking objective;
- transactions are invariably exchange[1] in nature;
- markets exist for these transactions to take place;
- asset values are largely arrived at by referring to future cashflows; and
- the main people using general purpose financial reports are investors, analysts, and regulators.

4.20 In my view, it is not surprising that standards built on these premises are not automatically suitable for the public sector. Such standards will not be readily transferable to public benefit entities unless enough amendments are made (including additional guidance for public benefit entities that takes account of the circumstances in which those entities operate and transactions common to those entities).

4.21 The contrast between the fundamental premises noted in paragraph 4.19 and how they might apply to public benefit entities is stark, as Figure 1 shows.

Figure 1
Applicability of IFRS premises to public benefit entities

Fundamental premise of IFRS	Applicability to public benefit entities
Entities have an overriding profit-seeking objective.	Public benefit entities have an overall objective of providing goods and services for community or social benefit.
Transactions are invariably exchange in nature.	Many of the transactions of public benefit entities are non-exchange in nature.
Markets exist for these transactions to take place.	Markets often do not exist. Public benefit entities hold many specialised assets and have obligations that cannot be readily transferred to third parties.
Asset values are largely arrived at by referring to future cashflows.	An assessment of value needs to take account of the nature and purpose of the entity (that is, to deliver future services to the community) rather than cashflows.
The main people using general purpose financial reports are investors, analysts, and regulators.	The main people using general purpose financial reports are Parliament and the public.

1 Exchange transactions are transactions involving two parties, a buyer and a seller, who agree to an exchange of approximately equal value. For example, exchange transactions include the sale of goods for cash or the provision of services for cash.

4.22 Another concern is that some governing bodies are now choosing to publicly denounce the use of NZ IFRS for their financial statements. I have seen comments such as:

- "provides neither a meaningful statement of performance nor a true and fair view of the statement of financial position";
- "the new rules unquestionably distort reported results and make the accounts more difficult for the average reader to understand"; and
- "while IFRS requires us to adopt these values, they are largely illusory and do not reflect the reality".

4.23 Although I do not fully agree with the way all of these comments are expressed, in my view, there are some real issues underlying the comments. Furthermore, irrespective of the actual comments, I am concerned when governing bodies feel the need to comment publicly that financial reporting standards based on IFRS are not leading to financial statements that are "fit for purpose".

Specific concerns about the suitability of NZ IFRS for the public sector

4.24 In paragraphs 4.26–4.88, I discuss some specific issues that lead me to question the suitability of requirements in NZ IFRS. I am also aware that with the pace of new requirements from the International Accounting Standards Board and the complexity already in IFRS, new issues will continue emerging.

4.25 I wrote to the Accounting Standards Review Board in March 2009 setting out most of these specific issues. My letter was in response to a request by the new chairman of the Accounting Standards Review Board to elaborate on my main concerns with NZ IFRS.

The language used is too focused on the private sector

4.26 The language pervading NZ IFRS is a major concern to me. That language, as one would expect of IFRS, focuses on profit-oriented entities. Little or no change has been made between IFRS and NZ IFRS to make the language more appropriate to a wider variety of entities. All too often, in my view, this means that the standards are hard to read and not particularly relevant to the circumstances faced by public benefit entities.

4.27 Difficulties with the language can make it harder for public benefit entities to apply the standards. It is harder because a mindset is needed where some of the words need to be subconsciously replaced with words that make sense in a public benefit entity context. The need for such a mindset affects the suitability of the standards because they are more difficult to understand in a public benefit entity context and more open to interpretation. Also, it is not always easy for those having to apply the standards to switch into that necessary mindset.

4.28 In my view, the issue of inappropriate language could have been lessened, to some extent, by including guidance or interpretation in NZ IFRS for public benefit entities. However, even though IFRS include a lot of guidance and interpretation for circumstances and transactions common to profit-oriented entities, there has been little such guidance or interpretation added to NZ IFRS for public benefit entities. I expect that my Office will have to make up for these deficiencies by providing guidance or interpretation for public benefit entities in the public sector.

4.29 I am concerned that my Office may need to provide guidance or interpretation in order for NZ IFRS to be fit for purpose in the public sector. My concerns are twofold:

- providing guidance and interpretation is more properly the job of the Financial Reporting Standards Board; and
- such a role is not ideal, given my statutory and professional obligations to remain independent.

The reporting of some public sector restructuring is misleading

4.30 I am concerned that financial reporting standards include inappropriate requirements for certain types of restructuring that can arise in the public sector. Those financial reporting standards are NZ IFRS 3 and the revised version of that standard.[2]

4.31 The scope of NZ IFRS 3 excludes restructuring situations involving entities or businesses that are controlled ultimately by the same party. This exclusion means that many of the types of restructuring common in the public sector (for example, the amalgamation of two entities controlled by the Crown) are sensibly excluded from the scope of the standard.

4.32 However, there are other types of restructuring that occur in the public sector that are not excluded from the scope of the standard. For example, the combining of two or more local authorities by an Act of Parliament, or by mutual agreement, would be within the scope of NZ IFRS 3.

4.33 Being within the scope of the standard means that purchase accounting must be applied to the restructuring. Purchase accounting requires one entity to be identified as the acquirer, and that entity acquires the other entity or entities. The fair value of the assets and liabilities of the acquired entity or entities must be calculated and accounted for. The difference between the fair value of net

2 NZ IFRS 3 (revised) was gazetted in February 2008 for application in periods beginning on or after 1 July 2009.

assets and the amount the acquirer pays for the entity or entities must also be accounted for.

4.34 In my view, purchase accounting is inappropriate in a restructuring situation such as when two or more local authorities combine. It does not make sense for one local authority to pay to acquire another local authority. Therefore, the entire fair value of the assets and liabilities of the local authority acquired would be recognised as a gain in the income statement of the local authority that is identified as the acquirer.

4.35 In my view, such accounting is a nonsense because it would give rise to misleading reporting. It would not reflect the substance of the restructuring taking place. I also have concerns about the costs of this requirement for what I see as no (or negative) benefit.

4.36 The scope of NZ IFRS 3 (revised) is similar to NZ IFRS 3. The revised standard requires the acquisition method to be used to account for restructuring. That method is very similar to purchase accounting. For restructuring such as the combining of two local authorities, the application of the revised standard would also give rise to reporting that is misleading because it would not reflect the substance of the restructuring taking place.

4.37 I acknowledge that my concern set out here was also a concern under previous standards. I am told that the Financial Reporting Standards Board thought specifically about the matter before issuing NZ IFRS 3 and NZ IFRS 3 (revised). If that is right, I do not understand why the Financial Reporting Standards Board decided against changing the standards for public benefit entities. However, I am aware that the Financial Reporting Standards Board now intends to reconsider this matter.

It is unclear which entities to include in a public sector group

4.38 I am concerned that the current requirements for group financial statements of public benefit entities are not clear. Those requirements are set out in the accounting standard NZ IAS 27.

4.39 The issue of group financial statements is an important issue for the public sector. Group financial statements have an effect on the transparency of reporting and accountability of many public sector entities, because they provide a picture of the combined available resources of, and use of those resources by, a "parent" entity.

4.40 The notion of "control" has been used for many years to decide which entities are consolidated into a group reporting entity. That notion has a difficult history in the public sector.

4.41 Before NZ IFRS, FRS-37 was the applicable financial reporting standard for group financial statements. FRS-37 was designed to address the application difficulties encountered in the public sector.

4.42 When NZ IAS 27 was being prepared, certain requirements and guidance from FRS-37 about control were kept for public benefit entities. The requirements and guidance were kept for public benefit entities by way of a cross-reference in NZ IAS 27 to parts of FRS-37.

4.43 There are different interpretations about what the cross-reference to parts of FRS-37 means. One interpretation is that the cross-referenced parts are only used to the extent that they are consistent with NZ IAS 27. Another interpretation is that those parts must be used to ensure that public benefit entities can appropriately apply NZ IAS 27. In my view, the second interpretation aligns with the intention of including the cross-reference. I consider the cross-referencing approach was a pragmatic response of the Financial Reporting Standards Board to avoid the need to make major changes to NZ IAS 27.

4.44 In addition to being open to interpretation, I am also concerned about proposed changes to NZ IAS 27. A proposed replacement standard for profit-oriented entities (referred to as exposure draft 10, or ED 10) was issued for comment by both the International Accounting Standards Board and the Financial Reporting Standards Board at the end of 2008. Although the Financial Reporting Standards Board has signalled its intention to take into account public benefit entity issues associated with ED 10, proposed changes or additions for public benefit entities have not yet been issued for comment.

4.45 In my view, significant changes for public benefit entities will need to be made to the proposed replacement standard based on ED 10. However, given the Financial Reporting Standards Board's general reluctance to make changes to NZ IFRS for public benefit entities, the replacement standard does not bode well for the public sector.

4.46 In my view, the most relevant accounting requirements to group financial statements of public benefit entities currently are those requirements in FRS-37. I do not want to imply that FRS-37 is ideal. However, of the material currently available, I consider FRS-37 best focuses on the substance of arrangements often found in the public sector. By substance, I mean where an entity has been able to secure and protect benefits from the activities of another entity, even if the first entity does not direct the day-to-day operations of the other entity.

4.47 I am concerned that the Financial Reporting Standards Board is planning to remove the FRS-37 requirements and guidance about control from NZ IFRS without having yet provided a suitable alternative for public benefit entities.

Typical public sector financial transactions are not adequately addressed

4.48 It is widely accepted that standards for financial instruments are the single biggest change in financial reporting resulting from NZ IFRS. Financial instruments include both financial assets (such as receivables) and financial liabilities (such as loans). Almost all reporting entities, including those in the public sector, have some form of financial instruments.

4.49 The bigger changes to financial reporting resulting from the standards for financial instruments are:

- recognition of all derivatives (such as interest rate swaps) on the balance sheet rather than disclosed in notes to the financial statements;
- recognition of financial guarantees on the balance sheet rather than disclosed in notes to the financial statements; and
- initial recognition of all financial assets and financial liabilities at fair value.

4.50 Under NZ IFRS, there are three standards covering recognition, measurement, presentation, and disclosure of financial instruments. Those standards are NZ IAS 32, NZ IAS 39, and NZ IFRS 7. Before NZ IFRS, there was only one standard on financial instruments covering disclosure requirements.

4.51 The financial instruments standards (which affect most reporting entities) contain no changes from the requirements of the IFRS, and no additional guidance for circumstances and transactions common to public benefit entities. I presume there are no changes or guidance because the Financial Reporting Standards Board considers that any differences between financial instruments in the public and private sectors do not warrant changes or guidance. However, in my view, there are some significant differences in the public sector that do warrant changes to requirements and additional guidance for public benefit entities.

4.52 The financial instruments standards do not adequately address common types of financial transactions found in the public sector, including:

- levying taxes, rates, and fines through use of legislative powers;
- granting or receiving concessionary loans; and
- providing financial guarantees in a non-exchange context (for example, the Government Deposit Guarantee scheme).

4.53 The three standards tend to be either irrelevant to the transactions (for example, the Crown accounting for sovereign receivables such as tax and fine receivables) or difficult to apply to the transactions. There can be difficulties applying the standards in practice because the nature of transactions typically found in the public sector are not the type of transactions envisaged by the International Accounting Standards Board when they established the standards.

4.54 In some instances, the financial instruments are complex and therefore difficult to account for. Complexity and accounting difficulties arise particularly when the substance of a financial instrument differs from the form of the arrangement. For example, public sector suspensory loans are often documented as liabilities but, in substance, are equity contributions.

4.55 I am also concerned about the effects on public sector entities of the current disclosure requirements associated with NZ IFRS 7. Public sector entities have needed to create new systems and processes to capture the information that now needs to be disclosed, despite the lack of any assessment of the value of such disclosures for those using the information in the financial statements. Also, the value of potentially more relevant disclosures for people using public sector entities' financial statements has not been properly assessed.

4.56 The underlying assumption of the Financial Reporting Standards Board seems to have been that if it is a disclosure requirement in IFRS, it should also be a disclosure requirement in NZ IFRS. That assumption does not take into account differences in the information needs of people using public sector entities' financial statements. The main people using private sector financial statements are investors, analysts, and regulators. In the public sector, the main users are Parliament and the public.

4.57 I consider that if the standards for financial instruments were looked at from a complexity, appropriateness, and cost-benefit perspective for people using financial statements, amendments would be warranted.

Public sector insurance liabilities are required to be conservatively calculated

4.58 The financial reporting standard for insurance (NZ IFRS 4) applies equally to private sector and public sector insurers.

4.59 NZ IFRS 4 requires insurers to calculate a liability for all outstanding claims and for that calculation to include a "risk margin". The risk margin means the liability for outstanding claims includes an amount above the estimated cost of settling the claims, based on a mid-point estimate. Rather than taking an approach of using a mid-point estimate, a more conservative estimate is required by the standard.

4.60 To me, it appears the rationale for increasing the liability above the mid-point estimate is to arrive at an amount a third party is likely to want to be paid to assume the risk of settling the claims. Such an amount is referred to as an exit value.

4.61 There are no exemptions for public benefit entities from the requirement to include a risk margin. Nor is there any guidance about the application of this requirement for public benefit entities.

4.62 In the public sector, the Accident Compensation Corporation (ACC) is the entity most affected by the requirements in NZ IFRS 4. Because ACC has incorporated a risk margin, about $2 billion has been added to its outstanding claims liability. That $2 billion is over and above the mid-point estimate of the amount that would be expected to be paid out in claims and is therefore an inherently conservative estimate of the outstanding claims liability.

4.63 Although funding issues can be distinguished from accounting treatment, in my view the risk margin requirement raises some important issues in the public sector:

- If public sector insurers such as ACC set levies and other funding requirements based on a liability that includes the risk margin, they are likely to recover levies and other funds at an amount over and above what they expect to pay out in claims.
- If, on the other hand, public sector insurers such as ACC set levies and other funding requirements based on a liability excluding the risk margin, it calls into question the relevance and usefulness of the liability figure required to be recognised in their financial statements.

4.64 I am told that in the case of ACC, levies and other funding is currently calculated using a mixture of both approaches: one for claims funded by levies (that includes the risk margin), and one for claims funded by the Crown (that excludes it).

4.65 Either way, I consider there are concerns about the requirement for inclusion of a risk margin in the public sector environment – exit value is seldom appropriate, except perhaps for assets and liabilities actively traded.

The required disclosures for related-party transactions are unclear

4.66 The disclosure of relevant related-party information is a critical element of accountability in the public sector. Disclosure is critical because transactions between related parties may not be made at the same amounts as they would be if the parties were unrelated.

4.67 Such information includes transactions between related entities and also transactions involving the people who govern and manage an entity. The latter group of transactions is particularly challenging in the public sector given the complex constitutional principles in place, particularly between Ministers and government departments.

4.68 NZ IAS 24 is the standard that sets out the related-party transaction disclosures required by reporting entities. NZ IAS 24 includes an exemption for public benefit entities that is designed to eliminate the need for unnecessary disclosure of routine related-party transactions between public sector entities. For example, the exemption means a public benefit entity in the public sector purchasing stamps from New Zealand Post, or paying ACC levies, does not need to make disclosures about the transactions.

4.69 The Financial Reporting Standards Board has been working for some time on improving the wording of an exemption for public benefit entities from certain disclosures. Also recently, the International Accounting Standards Board has released a draft proposal to reduce unnecessary disclosure of transactions with the State in the ordinary course of business.

4.70 Although I welcome initiatives to eliminate unnecessary disclosures, in my view more work is required by the Financial Reporting Standards Board to adequately deal with the issues. The Board needs to strike the right balance between:

- not requiring disclosure of information that does not materially affect the accountability of public sector entities; and
- requiring disclosure of information that is of likely interest to Parliament and the public, and that materially affects the accountability of public sector entities.

4.71 I have particular concerns about the disclosures required by public sector entities relating to transactions involving people who govern or manage an entity (or their close family members). The requirements for disclosure of these transactions are not clear and are open to interpretation.

4.72 I support the old adage that “sunlight is the best disinfectant”. In other words, I generally favour disclosure over non-disclosure of such transactions.

4.73 However, the standard currently requires disclosure of all transactions between a public sector entity and another party, where the party is a close family member of those in governance or management (for example, the employment of the spouse or child of a Minister of the Crown by a public sector entity).

4.74 In my view, the intent of requiring such disclosures is to capture transactions that are only entered into because the parties are related, and hence there is an increased risk of pecuniary benefit to the individual or the close family member. Therefore, in cases where a transaction takes place because of the related-party relationship, it is entirely appropriate to require full disclosure of the nature of the transaction.

4.75 However, where transactions are carried out without regard to, or influence from, related-party relationships, there is a risk that disclosure of transactions theoretically caught by the standard will be both unwieldy and of little use to people; for example, disclosure in the financial statements of the Government of all transactions involving close family members of Ministers with any public sector entity within the Crown.

4.76 Overall, in my view, the requirements governing disclosure of related-party transactions are not clear. Proposals to change these requirements, although well intentioned, are confusing and do not go far enough. Further work is needed, particularly in the area of disclosure of transactions involving individuals who are members of the governance or management of an entity (or close family members of those individuals).

The calculation of sick leave liabilities is costly and unclear

4.77 Until the adoption of NZ IFRS, New Zealand did not have a financial reporting standard that dealt with employee benefits. Despite not having a standard, most entities in the public sector accounted for employee benefits such as long-service leave and retiring leave.

4.78 NZ IAS 19 is a standard about employee benefits that was adopted as part of NZ IFRS. That standard confirms much of the accounting for employee benefits that had been carried out earlier. However, NZ IAS 19 also requires the accounting of sick leave liabilities in certain circumstances.

4.79 The recognition of sick leave liabilities stems from an underlying principle of NZ IAS 19: that a liability needs to be recognised when an employee has provided service in exchange for benefits to be paid in the future. Although sick leave affects all sectors, the nature of sick leave entitlements in the public sector typically makes it more significant than in other sectors.

4.80 A lot of cost and effort has gone in, and continues to go in, to applying NZ IAS 19 to sick leave benefit schemes in the public sector. Much of the cost arises because entities engage actuaries to calculate sick leave liabilities. I am concerned that the cost and effort is out of proportion to any benefit to be derived from calculating sick leave liabilities.

4.81 There are different interpretations about how NZ IAS 19 should be applied to some sick leave benefit schemes. Further, the interpretations result in significantly different sick leave liabilities. I am concerned that significant differences can arise in the amount of sick leave liabilities by applying the standard.

4.82 I am also aware that counter-intuitive outcomes can arise from applying the standard. For instance, some entities' sick leave benefit schemes periodically allocate a certain number of paid sick leave days to employees. Sick leave days not used can usually be carried forward into one or more future years. Other entities have wellness schemes where there is no allocation of "paid" sick leave days. These schemes work on the basis that sick leave is taken as needed and there is no specified maximum number of days in a period.

4.83 Applying NZ IAS 19 to the two schemes outlined above results in the recognition of a liability in the first instance but not in the second. The reason for the difference is technical, but relates to the underlying principle of NZ IAS 19. Nevertheless, I am concerned that financial statements will show a picture that, in some instances, is counter-intuitive to people using financial statements.

There has been a protracted debate over accounting for borrowing costs

4.84 In May 2007, the Financial Reporting Standards Board decided to eliminate the option for public benefit entities to record borrowing costs as an expense when they are associated with the construction of assets. The Accounting Standards Review Board approved the revised standard that incorporated that decision.

4.85 Since August 2007, I have been actively lobbying the Accounting Standards Review Board to withdraw its approval for the standard on borrowing costs (NZ IAS 23) unless the Financial Reporting Standards Board reinstates the option for public benefit entities to record such costs as an expense.[3] I have been lobbying because I consider that it is not appropriate to require compulsory capitalisation of borrowing costs.

4.86 I have several concerns about the elimination of the expense option and therefore the compulsory capitalisation of borrowing costs on construction projects. I am concerned that:

- capitalisation of general borrowings in the public sector is both complicated and arbitrary, and therefore unlikely to enhance the reliability of general purpose financial reports;

3 The Accounting Standards Review Board's powers are limited to approval or withdrawing approval of financial reporting standards submitted to it.

- there is no clear way to incorporate a component for borrowing costs into revaluations of most significant public sector assets, which is likely to make asset revaluations less reliable; and
- any benefits of capitalising borrowing costs are significantly outweighed by the compliance costs of initial capitalisation and subsequent revaluation of assets.

4.87 In November 2008, the Financial Reporting Standards Board submitted a standard to the Accounting Standards Review Board for approval that reinstated the option for public benefit entities to record borrowing costs as an expense rather than to require compulsory capitalisation of such costs. That standard was approved by the Accounting Standards Review Board. I was pleased to see the option reinstated, given the concerns associated with compulsory capitalisation noted above. However, getting the option reinstated for public benefit entities took 18 months of active lobbying from my Office.

4.88 The effort it took to get the option reinstated reinforced for me that fundamental change is needed to standard setting for the public sector. My Office cannot afford to devote the sort of resources that were necessary in this case to other major areas of concern to get common sense to prevail.

Other concerns

4.89 There are other issues in standards currently in force that I am concerned about. In my view, these other issues, although important, are secondary to those set out in paragraphs 4.26–4.88. Details of some other issues are included in Appendix 2.

Questions about the suitability of NZ IFRS for the public sector in future

4.90 In addition to my concerns with existing financial reporting standards, I am also concerned about several important changes that are happening internationally. These call into question the suitability of IFRS as a base for standards in New Zealand. In my view, it will become increasingly difficult for New Zealand to continue with the approach of NZ IFRS applying to all reporting entities, including public benefit entities. Even if the Financial Reporting Standards Board became amenable to making greater changes to NZ IFRS for public benefit entities, I still foresee problems with its suitability for those entities.

4.91 In my view, the changes happening internationally make it inevitable that, within the next few years, financial reporting standards will need to be more clearly separated. This is likely to mean that standards applying to selected profit-oriented entities will need separation from standards applying to public-benefit and other entities.

Two distinct international conceptual frameworks arising

4.92 There are two international projects under way that relate to the conceptual frameworks that underpin general purpose financial reporting. The International Accounting Standards Board is working on a project in conjunction with the United States Financial Accounting Standards Board (for the private sector), and the International Public Sector Accounting Standards Board has its own project (for the public sector). See Part 3 for more information about these projects.

4.93 These projects look likely to result in different approaches to what are fundamental matters in general purpose financial reporting. It looks as though there could be differences in the objectives and scope of general purpose financial reporting as well as in the definition of the most important components of financial statements, such as assets and liabilities.

4.94 To be useful, any conceptual framework needs to be relevant to the range of reporting entities covered by the financial reporting standards. The current situation means New Zealand needs a conceptual framework that adequately covers both profit-oriented entities and public benefit entities.

4.95 I expect the Financial Reporting Standards Board will have a significant challenge putting in place one appropriate conceptual framework for all entities. The challenge will be greater given the likelihood that the two international conceptual frameworks will continue to diverge rather than converge. Based on experience to date,[4] I expect the New Zealand framework will continue to be heavily based on the International Accounting Standards Board framework. That latter framework focuses solely on profit-oriented entities, with little regard for the different nature of public benefit entities as reflected in the International Public Sector Accounting Standards Board's work on its public sector conceptual framework.

4.96 In my view, having a New Zealand conceptual framework heavily based on the International Accounting Standards Board's revised conceptual framework would add to the existing general unsuitability of NZ IFRS for public benefit entities.

More complex presentation of financial statements likely

4.97 The International Accounting Standards Board has recently issued a discussion paper on financial statement presentation. The discussion paper includes proposals to revamp the presentation of the primary financial statements, typically referred to as the income statement and balance sheet.

4 The current NZ Framework is based on the International Accounting Standards Board Framework with some additional paragraphs. I was led to believe the additional paragraphs were a holding position and that the Financial Reporting Standards Board was going to revisit the framework in 2005. No such review has taken place as far as I am aware.

4.98 The proposals in the discussion paper are likely to add to the complexity of the primary financial statements. This, in turn, is likely to make them less understandable. In my view, the primary financial statements need to be kept as simple and straightforward as possible to help people to understand and make use of the information in the general purpose financial reports of entities.

4.99 In my view, information that is relevant but complex or detailed should be included in notes that accompany the primary financial statements. This ensures that all the relevant information is available for use by those who need it, but it also means the broad structure and flow of the financial statements remains understandable.

4.100 The proposals in the discussion paper also appear to be driven by a focus on cashflow information sought by analysts. In my view, that focus does not align well with the needs of people who use general purpose financial reports of public benefit entities.

4.101 In my view, there is a clear link between people's need for financial information with their need for non-financial information. Both types of information are needed to give a complete picture of the public benefit entity. Therefore, I think changes to the presentation of financial information should not be made without proper thought being given to how that information links with non-financial information.

4.102 I am concerned that the Financial Reporting Standards Board may adopt the new financial statement presentation for all reporting entities with little regard for the needs of people using public benefit entity financial statements. In my view, this will make it harder for people using such financial statements to hold those entities to account.

Redefining of liabilities likely

4.103 The International Accounting Standards Board has almost completed a project to change its standard on provisions, contingent liabilities, and contingent assets. That standard is IAS 37. Currently, provisions are recognised on the balance sheet when payment in the future is probable (that is, payment is more likely than not) to meet obligations.

4.104 The International Accounting Standards Board's proposals will move the notion of "probability" from the recognition criteria into the measurement of a provision. The result of the proposal will be the recognition of provisions on the balance sheet when payment is not probable. The International Accounting Standards Board's proposals will require provisions to be recognised for items currently disclosed as contingent liabilities in a note to the financial statements. Recognition will be required even if the probability of occurrence is not likely (for example, even if there is only a 10% chance of occurrence).

4.105 Apart from the measurement difficulties associated with the International Accounting Standards Board's proposals, and questions about the reliability of information, I would question the relevance of this approach in the public sector environment. Public sector obligations can seldom be settled by transferring them to third parties, as can occur in the private sector.

4.106 I understand the International Accounting Standards Board aims to issue its new liabilities standard before the end of 2009. I am concerned that the requirements of the new standard may be applied to public benefit entities in New Zealand, despite these difficulties and questions.

Concluding comments

4.107 Although some of the issues raised in this Part could be properly addressed by the Financial Reporting Standards Board, others are more systemic. The systemic issues are likely to remain problems as long as the approach in New Zealand is to apply NZ IFRS to all types of reporting entities, with minimal change for public benefit entities.

4.108 There are some current initiatives that provide an ideal opportunity to address issues with the suitability of standards based on IFRS for the public sector. I am aware of the review of the financial reporting framework being led by the Ministry of Economic Development. And I am also aware of the Accounting Standards Review Board's associated work to broadly set out the nature of reporting within the various reporting tiers in the framework.

Part 5
My views on changes that are needed

5.1 At the end of 2002, I was not concerned about the decision to adopt IFRS. I was optimistic that IFRS would be suitably adapted for public benefit entities, resulting in relevant and appropriate changes to financial reporting standards for entities in the public sector. However, that optimism has been eroded.

5.2 Since 2002, I have become increasingly concerned about the credibility of NZ IFRS applied by public benefit entities in the public sector. My views, expressed in Parts 2 to 4 of this discussion paper, bear witness to those increasing concerns.

5.3 I am convinced that major changes are now needed to the standard setting arrangements in New Zealand. In this Part I explain why I advocate significant changes and outline the changes that I consider are needed.

Why I advocate significant changes

5.4 I noted in two of my reports to Parliament in 2008[1] that if the right changes were not made to NZ IFRS in the future, there would be an increasing risk that the set of standards would not be of high quality nor ultimately fit for purpose for most of the public sector. I also noted that I had communicated these views to the then chairman of the Accounting Standards Review Board, because I considered the current approach was not serving the best interests of the public sector.

5.5 I have now lost confidence in the current approach used for setting standards, as it affects the public sector. Because of that loss of confidence, I have withdrawn the resources of my Office from the process for setting financial reporting standards in New Zealand. In my view, standard setting during the past 6½ years has resulted in NZ IFRS and IFRS being substantially the same as each other. I consider that not enough regard has been given to differences that exist between the private and public sectors. As a result, not enough regard has been given to the interests of people who use financial statements to hold public sector entities to account.

5.6 Near the end of 2008, I wrote to the Accounting Standards Review Board noting my view that continuing to apply NZ IFRS was not in the long-term best interests of most entities in the public sector. I came to this view because I consider the process used for adapting IFRS has unduly inhibited the establishment of high-quality financial reporting standards for the public sector. From the outset of the adoption of IFRS in 2002, I have advocated relevant and appropriate financial reporting standards for the public sector that can be used to properly hold public sector entities to account.

1 The reports were *Central government: Results of the 2006/07 audits*, Part 2: Transition to New Zealand equivalents to International Financial Reporting Standards, pages 19-26 and *Local government: Results of the 2006/07 audits*, Part 7: Transition to New Zealand equivalents to International Financial Reporting Standards, pages 49-56, which were presented on 21 May 2008 and 24 June 2008 respectively.

5.7 However, my comments about NZ IFRS should not be taken as a criticism of IFRS. I continue to support the adoption of IFRS by listed issuers in New Zealand and any other profit-oriented entities required to, or wishing to, state their compliance with IFRS. Adopting IFRS makes sense for those entities because IFRS are designed primarily for profit-oriented entities accessing capital markets.

5.8 In my view, the approach for establishing financial reporting standards in New Zealand has meant that the standards needed by the public sector have not been delivered. My attempts to get reasonable changes to the approach, supported by a more balanced membership of the Financial Reporting Standards Board, have, to date, been unsuccessful. As a result, I am advocating significant changes to the broad approach for setting financial reporting standards for public benefit entities in the public sector. I am also advocating changes in the responsibilities for standard setting.

The changes that I consider are needed

5.9 First and foremost, I think it is now imperative that IFRS is applied by only those reporting entities that IFRS were designed for, that is, profit-oriented entities accessing capital markets and any other profit-oriented entities required to, or wishing to, state their compliance with IFRS. In my view, these entities should adopt pure IFRS as established by the International Accounting Standards Board. Adopting pure IFRS for these entities would separate their need to state compliance with IFRS from the need for the standard setter to make relevant and appropriate changes for public benefit entities.

5.10 The question then becomes what to do about the remaining reporting entities, most of which are in either the public sector or the not-for-profit sector. By separating those entities applying pure IFRS from the remaining reporting entities, the crucial issue is how the standards should be set for these remaining entities. In other words, putting those entities applying pure IFRS to one side, how does the standard setter go about creating New Zealand standards for the other reporting entities, which include public sector entities?

5.11 In my view, the overall objective for the standard setter in setting New Zealand standards should be to set high-quality standards designed to produce general purpose financial reports that are understandable and that meet the needs of the people using them.

5.12 However, I acknowledge there are different approaches that could be used in future for setting financial reporting standards for public benefit entities in the public sector. I outline four such approaches below. These approaches may not be the only approaches that could be used.

5.13 To avoid any doubt, I reiterate that I do not consider that continuing with the status quo is a realistic option.

5.14 I describe the approaches as:

- enhancing IFRS;
- adopting International Public Sector Accounting Standards (IPSAS);
- enhancing IPSAS; and
- creating New Zealand standards.

Enhancing IFRS

5.15 By enhancing IFRS, I mean starting with IFRS but making appropriate changes for public benefit entities in the public sector. Such changes would include:

- removing standards that are not relevant to public benefit entities, and adding relevant standards from outside IFRS;
- altering language to make it relevant;
- removing unnecessary disclosure requirements;
- altering recognition, measurement, or presentation requirements where necessary; and
- adding guidance and relevant disclosure requirements.

5.16 In effect, I see enhancing IFRS as similar to the current approach where NZ IFRS can be applied by all reporting entities, but doing it a lot better. The approach would be better because it would remove the artificial constraints which currently exist when making changes for public benefit entities.

5.17 By separating those entities applying pure IFRS from the remaining entities, there should no longer be any concerns about the potential for changes in NZ IFRS to affect how profit-oriented entities apply IFRS. This is because the standards will no longer be packaged together as is the case now.

Adopting IPSAS

5.18 Adopting IPSAS for public benefit entities in the public sector, would, in my view, work along similar lines to adopting IFRS for the private sector. Adopting IPSAS would mean making minimal changes to those standards. Changes would be limited to:

- removing options where IPSAS contained alternative permissible treatments; and
- adding disclosure requirements.

5.19 Adopting IPSAS for public benefit entities in the public sector would create a need for standards for public benefit entities in the not-for-profit sector and those profit-oriented entities that are not adopting pure IFRS.

Enhancing IPSAS

5.20 Enhancing IPSAS would entail starting with IPSAS and making appropriate changes for application by public benefit entities in the public sector. Such changes would include:

- altering the language to make it relevant to the New Zealand situation;
- removing or adding disclosure requirements;
- altering recognition, measurement, or presentation requirements where necessary;
- adding relevant standards from outside IPSAS; and
- adding relevant guidance.

5.21 Enhancing IPSAS for public benefit entities in the public sector could readily be extended to include enhancements for public benefit entities in the not-for-profit sector. However, there would still be a need for standards for those profit-oriented entities that are not adopting pure IFRS.

Creating New Zealand standards

5.22 Creating New Zealand standards for all reporting entities, other than those adopting pure IFRS, would provide the standard setter with no defined starting point. Rather, the standard setter would be free to draw on principles, ideas, and requirements from various sources, including IPSAS and IFRS.

5.23 Each of the four approaches would have some benefits and drawbacks for the public sector. There would also be implications for other sectors. Figures 2 to 5 compare each of the four approaches in terms of what each would mean for the public and other sectors.

Figure 2
Enhancing IFRS

What enhancing IFRS would mean for the public sector	What enhancing IFRS would mean for other sectors
This approach, if done properly, should result in standards that could be applied relatively easily by public benefit entities in the public sector. Using IFRS as the starting point would help to ensure that broad requirements are the same for both profit-oriented entities and public benefit entities. Having the same broad requirements would mean that accounting skills are more readily transferable between sectors than the other approaches. This approach would also avoid a second upheaval in making the transition to a new set of standards. A drawback of this approach is that, because IFRS are written for profit-oriented entities, significant changes would be needed to make the standards suitable for public benefit entities. A need for significant changes would mean more effort is needed to set standards, which typically translates into higher standard-setting costs. Also, in my view, given the history of minimal changes to IFRS, I have doubts that this approach would be done properly. For it to succeed, there would need to be a big change in attitude. Although it would be possible to follow this approach in the short term, it is likely to become increasingly difficult, given what is happening internationally (see Part 4, starting at paragraph 4.90).	The standards applying to all sectors (including profit-oriented entities in the private and public sectors and not-for-profit entities) could continue to be "packaged" together, as is the case now with NZ IFRS. Differences between these sectors could be built into the resulting standards. This may mean more differentiation between public benefit entities in the public sector and the not-for-profit sector. It is likely there would continue to be some practical limitations on the extent of changes made for differences between the sectors, but only if the differences are inconsequential.

Figure 3
Adopting IPSAS

What adopting IPSAS would mean for the public sector	What adopting IPSAS would mean for other sectors
This approach should result in standards that are inherently suitable for public benefit entities in the public sector, because IPSAS have been designed specifically for those entities. An advantage of IPSAS is that many of the standards are based on IFRS but already include the changes the International Public Sector Accounting Standards Board thought were needed for application in the public sector. The fact that many IPSAS are based on IFRS should mean that the transferability of accounting skills between sectors would be only a little more difficult than an approach of enhancing IFRS. Direct adoption of IPSAS would also mean low standard-setting costs. A drawback of adopting IPSAS with minimal change is that New Zealand would be unable to make changes where standards were unclear or not entirely appropriate (that is, New Zealand would have to accept all the standards regardless of their appropriateness). I am not aware of any compelling reason to have to accept IPSAS the way IFRS are now accepted for profit-oriented entities. Adopting IPSAS could mean compromising on high-quality financial reporting standards, at least in the short- to medium-term. I do not advocate compromising on high-quality, fit-for-purpose financial reporting standards for the public sector.	New Zealand standards derived from adopting IPSAS would be inherently suitable only for public benefit entities in the public sector. This would create the need for additional guidance or different requirements for entities in the not-for-profit sector. This would also create the need for standards for those profit-oriented entities that are not adopting pure IFRS.

Figure 4
Enhancing IPSAS

What enhancing IPSAS would mean for the public sector	What enhancing IPSAS would mean for other sectors
This approach should result in suitable standards that could be applied relatively easily by public benefit entities in the public sector. Using IPSAS as a starting point would result in fewer changes being required compared to starting with IFRS, given that the International Public Sector Accounting Standards Board designs its standards for the public sector. Being able to make changes to IPSAS would mean New Zealand could have high-quality, fit-for-purpose financial reporting standards for the public sector (something that would not necessarily happen in all instances if New Zealand chose the approach of adopting IPSAS). A drawback of allowing changes to be made to IPSAS is the likelihood that standard-setting costs would be higher than directly adopting IPSAS. Also, depending on the extent of change, the transferability of accounting skills would be a little more difficult than an approach of enhancing IFRS.	The standards derived from this approach should be suitable for public benefit entities in both the public sector and the not-for-profit sector. However, this would still create the need for standards for those profit-oriented entities that are not adopting pure IFRS.

Figure 5
Creating New Zealand standards

What creating New Zealand standards would mean for the public sector	What creating New Zealand standards would mean for other sectors
This approach, if done properly, should result in standards that could be applied relatively easily by public benefit entities in the public sector. Allowing the standard setter to draw on principles, ideas, and requirements from many sources should result in the best quality financial reporting standards compared with the other three approaches. Standards could be specifically designed to produce financial reports that are understandable and more readily able to be used to properly hold public sector entities to account. A drawback of this approach is that it would require a significantly greater intellectual investment in the standard-setting process. This approach would also be the most expensive to put in place properly, and it would result in standards taking longer to put into place. It is likely the New Zealand standards would be significantly different from IFRS, resulting in accounting skills not being as readily transferable between profit-oriented entities and public benefit entities as the other approaches. Also, there is a risk that, in taking a mainly "New Zealand approach", the resulting standards may not receive the necessary international recognition.	The standards derived by this approach should be suitable for all entities in the public sector and not-for-profit sector, and for those profit-oriented entities that are not adopting pure IFRS.

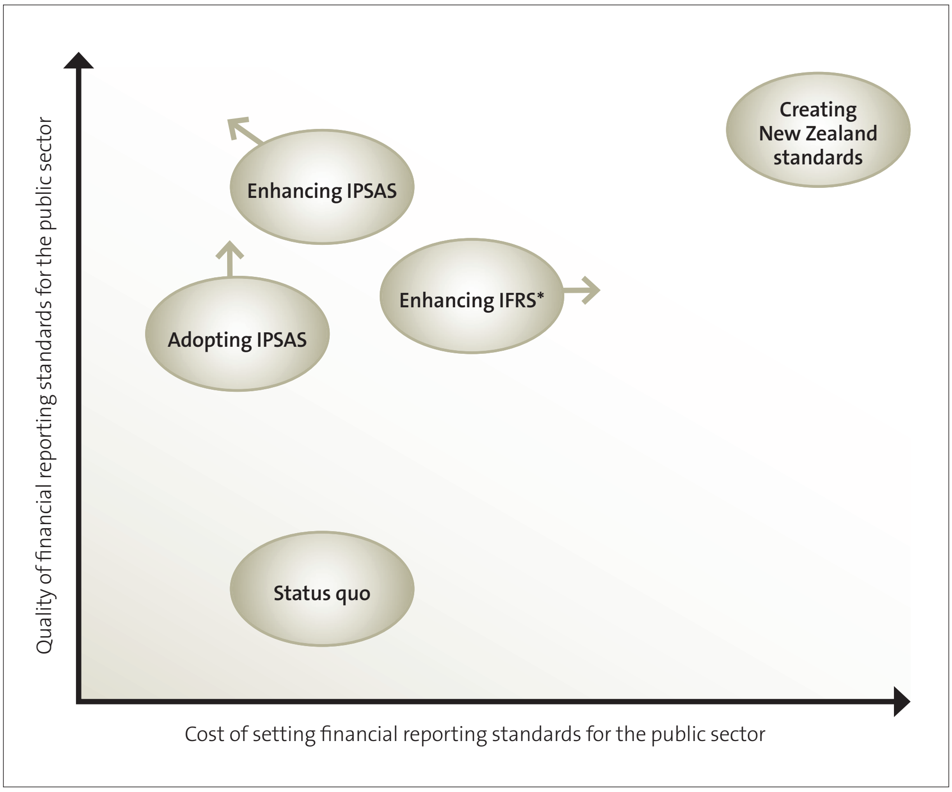
5.24 Essentially, I see that the preferred approach comes down to a trade-off between the quality of the standards sought (including the ability of entities to readily apply the standards), and the cost of setting standards to achieve that quality. Figure 6 shows my assessment of the quality versus cost trade-off, and what I see to be the likely trends associated with the first three approaches.

5.25 The transferability of accounting skills between the public, private and not-for-profit sectors is a factor to be considered also. On the face of it, similar standards between the sectors should help the transferability of accounting skills.

5.26 However, in my view, the transferability of accounting skills depends on the suitability of the standards. NZ IFRS may, in fact, have overstated the transferability of accounting skills because they give a false sense that the public sector is almost the same as the private sector. As a result, NZ IFRS may be applied to public sector circumstances and transactions as though they were the same as in the private sector, when in fact they can be quite different. Establishing the right standards for each sector should help to ensure the differences between the sectors are transparent.

Figure 6

Assessment of four new approaches for establishing financial reporting standards for the public sector



* My assessment of enhancing IFRS is on the basis that it is not simply a continuation of the status quo (that is, all relevant and appropriate changes are expected to be made between IFRS and NZ IFRS under this approach).

5.27 As Figure 6 shows, I see the cost of enhancing IFRS increasing over time as IFRS, on which this approach is based, become increasingly unsuitable for public benefit entities and requires more change. I see the quality of the standards resulting from adopting IPSAS improving over time as the International Public Sector Accounting Standards Board continues to gain credibility as an international standard setter for the public sector. For the same reason, I also see the quality of the standards resulting from enhancing IPSAS improving over time, while I also see a reduction over time in the cost of the process for enhancing the standards. I do not see any trends associated with creating New Zealand standards.

5.28 As well as a decision on how a set of New Zealand financial reporting standards will be created in future, there will need to be a decision about appropriate differential requirements for small entities. In my view, irrespective of the approach adopted, it is important to ensure that the reporting requirements for small entities broadly reflect their size and complexity, and the needs of people using the information reported.

5.29 The current differential reporting framework is designed to ease the compliance burden on smaller entities. Following the deferral of mandatory adoption of NZ IFRS (as outlined in Part 2, starting at paragraph 2.59), fewer small entities in the private sector reported in accordance with NZ IFRS. However, most smaller entities in the public sector were unable to defer NZ IFRS. Therefore, the standard setter now needs to review the differential reporting concessions available to small entities, particularly for the public sector.

5.30 In my view, more concessions should be available to smaller entities in the public sector. This would ensure that the accountability obligations of such entities are not disproportionate to their size while still meeting the needs of people using their financial statements. It may be that a simplified set of requirements can be established for certain homogenous sub-sectors within the public sector (for example, the schools sector).

5.31 Associated with any change in the approach to setting standards would be a need to review the way standard setting is carried out.

5.32 For the past 16 years, there have been two parties involved in setting financial reporting standards: the Financial Reporting Standards Board that writes standards, and the Accounting Standards Review Board that reviews and approves those standards. Therefore, setting financial reporting standards has required the co-operation of both boards.

5.33 Having two separate parties involved in setting financial reporting standards is different from what happens in other jurisdictions such as Australia, the United Kingdom, Canada, and the United States. In those jurisdictions the body that writes the standards sets the standards.

5.34 In my view, the writing and approving of financial reporting standards needs to be the responsibility of one board, a statutory board. I acknowledge that there would need to be changes to the Accounting Standards Review Board's powers for it to be that statutory board. This would require legislative change.

5.35 The members of the statutory board would need to be selected from appropriately skilled people, so that collectively the board had experience in dealing with issues across the range of reporting entities for which standards are set.

Concluding comments

5.36 In my view, the Accounting Standards Review Board needs to be given the power to create financial reporting standards (as opposed to only approving or not approving standards submitted to it). If the Board had that power, it could then decide the best way forward and implement it so that standard setting for the public sector could be put "back on track".

5.37 In my view, significant change rather than fine tuning is required. Such changes would include requiring, at least, listed issuers to adopt pure IFRS, and allowing any other profit-oriented entities wishing to state their compliance with IFRS to also adopt pure IFRS. In this way, these entities would be using standards designed for them.

5.38 The challenge for the Accounting Standards Review Board would then be to decide the most appropriate approach to setting standards for all other reporting entities. I have outlined four broad approaches the Accounting Standards Review Board could think about. The underlying premise of these four approaches is that continuing the status quo is not an option.

5.39 All four approaches have advantages and disadvantages. In my view, any assessment of these various approaches essentially comes down to a trade-off between quality of financial reporting standards (including the ability of entities to readily apply the standards) and the cost of setting standards to achieve that quality. I would strongly prefer an approach that emphasises the quality of financial reporting standards for the public sector.

Appendix 1
Comparing NZ IFRS with previous financial reporting standards for the public sector

A1.1 This Appendix compares NZ IFRS for public benefit entities with financial reporting standards that applied before NZ IFRS (referred to in this Appendix as "previous standards"). The comparison is based on the standards and interpretations in place under NZ IFRS as at 31 March 2009.

A1.2 Interpretations of standards, referred to as NZ SIC and NZ IFRIC, have been linked where possible to the standard to which they primarily relate. NZ SIC are the New Zealand equivalents to interpretations established by the former Standard Interpretations Committee and the NZ IFRIC are the New Zealand equivalents to interpretations established by the International Financial Reporting Interpretations Committee.

A1.3 The comments reflect the judgements my staff and I have made, at a high level, about what has been gained or lost from the adoption of NZ IFRS.

NZ IFRS standard	Previous standard	Comments
NZ Framework *New Zealand Equivalent to the IASB Framework for the Preparation and Presentation of Financial Statements*	*Statement of Concepts for General Purpose Financial Reporting*	The NZ Framework includes some paragraphs to reflect the public benefit entity environment. However, the NZ Framework contains less guidance than the previous Statement of Concepts in important areas (for example, contributions by owners). This is a problem for the public sector.
NZ IFRS 1 *First-time Adoption of New Zealand Equivalents to International Financial Reporting Standards*	No previous standard on this subject	NZ IFRS 1 relates to the transition to NZ IFRS. In general, I am not aware of any concerns with this standard for the public sector.
NZ IFRS 2 *Share-based Payment* (includes interpretations NZ IFRIC 8 and NZ IFRIC 11)	No previous standard on this subject	NZ IFRS 2 generally does not apply to the public sector, except for listed entities such as Air New Zealand.

NZ IFRS standard	Previous standard	Comments
NZ IFRS 3 (revised) *Business Combinations*	FRS-36 *Accounting for Acquisitions Resulting in Combinations of Entities or Operations*	NZ IFRS 3 (revised) includes some changes from the previous standard, such as the requirement to value and recognise contingent liabilities acquired, and the prohibition on amortising goodwill. NZ IFRS 3 (revised) includes no changes from IFRS 3 (revised) and includes no guidance for public benefit entities. I am concerned that applying NZ IFRS 3 (revised) in some instances might result in misleading information for people using public benefit entities' financial statements. This was also the case under FRS-36.
NZ IFRS 4 *Insurance Contracts*	FRS-34 *Life Insurance Business* and FRS-35 *Financial Reporting of Insurance Activities*	NZ IFRS 4 includes some changes from previous standards. For example, NZ IFRS 4 requires a claims liability to be greater than the mid-point estimate of the liability. The liability is increased by applying a risk margin and is likely to be higher than the amount expected to be paid out in claims. I am concerned that including a risk margin for a public sector insurer may not give appropriate information to people using the financial statements of such insurers.
NZ IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*	No previous standard on this subject, but there was some guidance in: FRS-2 *Presentation of Financial Reports*; FRS-3 *Accounting for Property, Plant and Equipment*; FRS-9 *Information to be Disclosed in Financial Statements*; and SSAP 17 *Accounting for Investment Properties and Properties Intended for Sale*	NZ IFRS 5 consolidates previous guidance, and changes some requirements (for example, assets classified as held for sale are not to be depreciated). However, there are issues specific to the public sector relating to property disposals that have not been included.
NZ IFRS 6 *Exploration for and Evaluation of Mineral Resources*	No previous standard on this subject	NZ IFRS 6 has limited applicability in the public sector.

NZ IFRS standard	Previous standard	Comments
NZ IFRS 7 *Financial Instruments: Disclosures*	FRS-31 *Disclosure of Information about Financial Instruments* and FRS-33 *Disclosure of Information by Financial Institutions*	NZ IFRS 7 is more comprehensive than previous standards. NZ IFRS 7 includes no changes from IFRS 7 for public benefit entities, and therefore all requirements apply to the public sector. I am not aware of any assessment of the value of the new disclosures for people using public benefit entities' financial statements, but I question the relevance of some of these new disclosures (for example, some of the required disclosures about credit risk).
NZ IFRS 8 *Operating Segments*	SSAP-23 *Financial Reporting for Segments*	NZ IFRS 8 sensibly does not apply to public benefit entities, given that the "management focus" required by NZ IFRS 8 is unlikely to be consistent with the accountability requirements of many public sector entities.
NZ IAS 1 *Presentation of Financial Statements* (includes interpretation NZ SIC 29)	FRS-2 *Presentation of Financial Reports* and FRS-9 *Information to be Disclosed in Financial Statements*	NZ IAS 1 covers similar areas as previous standards. However, NZ IAS 1 requires more disclosures. One such disclosure is about how an entity manages its "capital", which is of questionable value to people using most public benefit entities' financial statements.
NZ IAS 2 *Inventories*	FRS-4 *Accounting for Inventories*	NZ IAS 2 includes no major changes from the previous standard. However, NZ IAS 2 requires more disclosures (for example, the amount of write-down in inventories recognised as an expense). Such disclosures seem reasonable.
NZ IAS 7 *Cash Flow Statements*	FRS-10 *Statement of Cash Flows*	NZ IAS 7 includes no major changes from previous standards. However, NZ IAS 7 contains less guidance about such matters as GST.

NZ IFRS standard	Previous standard	Comments
NZ IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*	FRS-1 *Disclosure of Accounting Policies* and FRS-7 *Extraordinary Items and Fundamental Errors*	NZ IAS 8 includes some changes from previous standards. NZ IAS 8 requires retrospective adjustments for changes in accounting policy and correction of all material errors. Also, NZ IAS 8 requires more disclosures, including the effects of new standards that have been issued but have yet to be put in place. Some of these disclosures are of questionable value to people using public benefit entities' financial statements.
NZ IAS 10 *Events after the Balance Sheet Date* (includes interpretation NZ IFRIC 17)	FRS-5 *Events after Balance Date*	NZ IAS 10 includes no major changes from the previous standard.
NZ IAS 11 *Construction Contracts*	FRS-14 *Accounting for Construction Contracts*	NZ IAS 11 includes no major changes from the previous standard. However, NZ IAS 11 contains more guidance and requires more disclosures.
NZ IAS 12 *Income Taxes* (includes interpretations NZ SIC 21 and NZ SIC 25)	SSAP-12 *Accounting for Income Tax*	NZ IAS 12 is unlikely to affect many public benefit entities because most such entities are not subject to income tax. NZ IAS 12 includes a major change in the basis of calculating deferred tax for all tax-paying entities. The biggest effects in the public sector are on tax-paying entities with large infrastructure assets that are revalued. A deferred tax liability is recognised that is well in excess of the present value of any future tax liability that is likely to be assessed.
NZ IAS 16 *Property, Plant and Equipment*	FRS-3 *Accounting for Property, Plant and Equipment*	NZ IAS 16 includes no major changes from previous standards. However, NZ IAS 16 contains less guidance on certain issues (for example, subsequent expenditure, components, and use of indices in a depreciated replacement cost valuation). Much of the material from the previous standard that has not been included in NZ IAS 16 directly affects the public sector.

NZ IFRS standard	Previous standard	Comments
NZ IAS 17 *Leases* (includes interpretations NZ SIC 15, NZ SIC 27, and NZ IFRIC 4)	SSAP-18 *Accounting for Leases and Hire Purchase Contracts*	NZ IAS 17 includes no major changes from previous standards. However, NZ IAS 17 requires additional disclosures for both lessees and lessors, which seem reasonable.
NZ IAS 18 *Revenue* (includes interpretations NZ SIC 31, NZ IFRIC 13, NZ IFRIC 15, and NZ IFRIC 17)	No previous standard on this subject	NZ IAS 18 deals only with revenue from exchange transactions; therefore it does not cover many of the revenue transactions in the public sector. NZ IAS 18 is not particularly clear, and is confusing and contradictory between the standard and examples set out in the appendix. The real issue for the public sector is non-exchange revenue, for which there is currently no standard under NZ IFRS. A proposed standard is expected to be issued for comment soon.
NZ IAS 19 *Employee Benefits* (includes interpretation NZ IFRIC 14)	No previous standard on this subject	NZ IAS 19 introduced the requirement to recognise a liability for sick leave, which required a significant amount of work in the transition to NZ IFRS. The standard is not clear about the calculation of liabilities for some sick leave benefit schemes common in the public sector. It is questionable whether the requirement to recognise a sick leave liability meets the cost-benefit test. Also, NZ IAS 19 requires use of the high-quality corporate bond rate for all entities in discounting long-term employee benefits. (If there is no deep market for corporate bonds, use of the government bond rate is permitted.) The corporate bond rate is not relevant to the public sector.
NZ IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* (includes interpretation NZ SIC 10)	No previous standard on this subject	NZ IAS 20 does not apply to public benefit entities. I am pleased about this, given it would otherwise result in misleading financial statements being produced by many public benefit entities. I am of the view that NZ IAS 20 is a poor quality standard, and I support its non-application to public benefit entities.

NZ IFRS standard	Previous standard	Comments
NZ IAS 21 *The Effects of Changes in Foreign Exchange Rates* (includes interpretation NZ SIC 7)	FRS-21 *Accounting for the Effects of Changes in Foreign Currency Exchange Rates* and SSAP-21 *Accounting for the Effects of Changes in Foreign Currency Exchange Rates*	NZ IAS 21 includes no major changes from previous standards relating to the translation of transactions in foreign currency. However, there are some changes relating to translation of amounts recorded by foreign entities. In general, I am not aware of any concerns with this standard for the public sector.
NZ IAS 23 *Borrowing Costs*	No previous standard on this subject, but requirements relating to borrowing costs were included in FRS-3 and FRS-4	NZ IAS 23 currently includes an option about borrowing costs for public benefit entities. Borrowing costs can be capitalised as part of the cost of a construction project or recognised as an expense. Having the option aligns with the requirements included in previous standards. The option has only recently been reinstated for public benefit entities after protracted correspondence between the Accounting Standards Review Board and me.
NZ IAS 24 *Related Party Disclosures*	SSAP-22 *Related Party Disclosures*	NZ IAS 24 includes more disclosures for related-party transactions, a generally positive requirement in the public sector. However, the exemptions relating to unnecessary disclosures need revision. Exemptions are subject to reconsideration by the Financial Reporting Standards Board.
NZ IAS 26 *Accounting and Reporting by Retirement Benefit Plans*	FRS-32 *Financial Reporting by Superannuation Schemes*	NZ IAS 26 includes no major changes from previous standards. NZ IAS 26 affects very few entities in the public sector. The Financial Reporting Standards Board is currently looking at whether to recommend withdrawing NZ IAS 26.

NZ IFRS standard	Previous standard	Comments
NZ IAS 27 *Consolidated and Separate Financial Statements* (includes interpretation NZ SIC 12)	FRS-37 *Consolidating Investments in Subsidiaries*	NZ IAS 27 includes less direct guidance on the crucial concept of "control" than was contained in the previous standard. However, public benefit entities are still required to follow relevant paragraphs from FRS-37 to decide if they control another entity. The International Accounting Standards Board proposed a new standard on group financial statements at the end of 2008. The Financial Reporting Standards Board plans to adapt that standard for public benefit entities and remove the requirement for those entities to follow relevant paragraphs from FRS-37.
NZ IAS 28 *Investments in Associates*	FRS-38 *Accounting for Investments in Associates*	NZ IAS 28 has a narrower scope than the previous standard, but provides more flexibility about when equity accounting should apply.
NZ IAS 29 *Financial Reporting in Hyperinflationary Economies* (includes interpretation NZ IFRIC 7)	No previous standard on this subject	NZ IAS 29 is not expected to be relevant to New Zealand.
NZ IAS 31 *Interests in Joint Ventures* (includes interpretation NZ SIC 13)	SSAP-25 *Accounting for Interests in Joint Ventures and Partnerships*	NZ IAS 31 has a wider scope than the previous standard in that it covers: • jointly controlled operations; • jointly controlled entities; and • jointly controlled assets. NZ IAS 31 also requires more disclosures.

NZ IFRS standard	Previous standard	Comments
NZ IAS 32 *Financial Instruments: Presentation* (includes interpretation NZ IFRIC 2)	FRS-31 *Disclosure of Information about Financial Instruments* FRS-27 *Right of Set-off* FRS-26 *Accounting for Defeasance of Debt* and FRS-21 *Accounting for the Effects of Changes in Foreign Currency Exchange Rates*	NZ IAS 32 includes some changes from previous standards, particularly about what is a liability and consequently what is recognised as equity. NZ IAS 32 includes no changes from IAS 32 for public benefit entities. As a consequence, the standard is difficult to apply to some transactions commonly found in the public sector (for example, suspensory loans).
NZ IAS 33 *Earnings per Share*	No previous standard on this subject	NZ IAS 33 has limited applicability in the public sector because it applies only to listed entities such as port companies.
NZ IAS 34 *Interim Financial Reporting* (includes interpretation NZ IFRIC 10)	FRS-24 *Interim Financial Statements*	NZ IAS 34 includes no major changes from the previous standard, but more disclosures are now required.
NZ IAS 36 *Impairment of Assets*	No previous standard on this subject, but requirements relating to impairment of property, plant, and equipment were included in FRS-3 *Accounting for Property, Plant and Equipment*	NZ IAS 36 has a wider scope. The standard has sensibly been amended in relation to non-cash-generating property, plant, and equipment. However, the amendment is not clear for the impairment of some other non-cash-generating assets.
NZ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (includes interpretations NZ IFRIC 1, NZ IFRIC 5, and NZ IFRIC 6)	FRS-15 *Provisions, Contingent Liabilities and Contingent Assets*	NZ IAS 37 includes no major changes to the accounting requirements for provisions and contingent liabilities. However, there are changes to requirements for contingent assets. The International Accounting Standards Board has proposed a new standard on non-financial liabilities to replace the standard about provisions, contingent liabilities, and contingent assets. The proposed standard contains significant changes from IAS 37.

NZ IFRS standard	Previous standard	Comments
NZ IAS 38 *Intangible Assets* (includes interpretation NZ SIC 32)	FRS-13 *Accounting for Research and Development activities* and SSAP 3 *Accounting for Depreciation* Also, there was a previous exposure draft, ED-87 *Accounting for Intangible Assets*	NZ IAS 38 broadens the scope from previous standards, which were focused on research and development. NZ IAS 38 requires recognition of intangible assets but only if there is a reliable cost. That requirement can be a problem for public benefit entities receiving intangible assets for nil or a nominal amount. NZ IAS 38 does not address public sector intangible asset issues such as the creation of radio spectrum licences, fishing quota, and emission trading units.
NZ IAS 39 *Financial Instruments: Recognition and Measurement* (includes interpretations NZ IFRIC 9 and NZ IFRIC 16)	No previous standard covering recognition and measurement of financial instruments	NZ IAS 39 has had a major effect on financial reporting by all reporting entities. The main changes include: • recognition of all derivatives; • recognition of financial guarantees; and • initial recognition of all financial assets/financial liabilities at fair value. NZ IAS 39 is a complex standard that has had several amendments and adjustments since it was first put in place. NZ IAS 39 includes no changes from IAS 39 and includes no specific guidance for circumstances and transactions common to public benefit entities. Several important public sector issues (such as suspensory loans, low interest loans, and financial guarantees) are not adequately dealt with by the standard. Also, NZ IAS 39 does not deal with non-contractual instruments (such as tax and fines receivables) that are relevant to the public sector.

NZ IFRS standard	Previous standard	Comments
NZ IAS 40 *Investment Property*	SSAP-17 *Accounting for Investment Properties and Properties Intended for Sale* and FRS-3 *Accounting for Property, Plant and Equipment*	NZ IAS 40 includes some changes from previous standards. For example: • all changes in fair value are required to be recognised through the income statement; and • disposal costs are not deducted from the valuation of investment properties. These changes do not appear to give rise to any particular concerns for the public sector.
NZ IAS 41 *Agriculture*	No previous standard on this subject. However, there was a previous exposure draft, ED-90 *Agriculture*	NZ IAS 41 is a new standard that requires agriculture assets to be revalued annually and for changes in value to be recognised through the income statement. The standard applies mainly to forestry assets in the public sector. I am aware of some cost-benefit concerns with this standard for the public sector.
NZ IFRIC 12 *Service Concession Arrangements*	No previous standard on this subject	Although NZ IFRIC 12 is labelled as an interpretation, it does not interpret existing NZ IFRS because existing standards do not deal with the subject of accounting for service concession arrangements (also known as public private partnerships). NZ IFRIC 12 sets out general principles relating to service concession arrangements for private sector operators. The interpretation does not specify the accounting by public sector entities responsible for specifying the nature of the service. There is a need for authoritative requirements for public sector entities.
FRS-42 *Prospective Financial Statements*	FRS-29 *Prospective Financial Information*	FRS-42 is a standard created with all entities in mind (that is, the standard is sector neutral). FRS-42 is not part of IFRS standards; nonetheless, it is part of NZ IFRS.
FRS-43 *Summary Financial Statements*	FRS-39 *Summary Financial Reports*	FRS-43 is an improved standard updated for NZ IFRS but largely in line with the previous standard. FRS-43 is not part of IFRS standards; nonetheless, it is part of NZ IFRS.

Appendix 2
Other concerns about the suitability of NZ IFRS for the public sector

A2.1 This Appendix includes some specific implementation issues with NZ IFRS affecting public benefit entities, other than those reported in Part 4. These issues, in conjunction with the issues identified in Part 4, are not intended to represent a full list of implementation issues. Rather, they are included to show that there are many issues with NZ IFRS for public benefit entities. In my view, issues with implementing NZ IFRS are likely to continue emerging.

Unnecessary disclosures about standards that do not yet apply

A2.2 NZ IFRS include a standard on accounting policies (NZ IAS 8).

A2.3 One of the requirements of NZ IAS 8 is to disclose information about new standards that have yet to be applied by the entity. Also, information that allows an assessment of the possible effect of new standards, when they are first applied, must be disclosed.

A2.4 Such disclosures are likely to benefit people using the financial statements of listed companies. Those people are more likely to be interested in comparing entities to help them with decisions about where to allocate resources.

A2.5 However, in my view, such disclosures are of little benefit to people using financial statements of most public sector entities. People using those entities' financial statements are more likely to be interested in accountability of the entities concerned. When it comes to comparability, comparing entities' results to forecasts is usually more important than any significant comparison with other entities.

A2.6 This unnecessary disclosure also adds costs. In my view, the people using the financial statements of most public sector entities do not need such information, therefore the requirement should be removed for public benefit entities.

No guidance about ownership transactions without equity instruments

A2.7 In the private sector, transactions between entities and their owners are usually well defined. For example, a company normally issues shares to its owners when those owners invest in the company. From time to time, dividends are paid by the company to its owners, based on the number of shares the owners have.

A2.8 NZ IFRS have been based almost entirely on the above notions of ownership transactions. These notions are not relevant for most public benefit entities. Share certificates or other forms of equity instruments are not generally issued by public benefit entities in the public sector, and most of those entities do not pay dividends.

A2.9 Throughout the public sector, there are many transfers of resources to and from "parent" entities and "subsidiary" entities. Because of the way the public sector is structured, many of these transactions occur through intermediaries. Therefore, it is not always clear whether the transfer of resources between parent entities and subsidiary entities are revenues or expenses, or contributions from, or distributions to, owners.

A2.10 Given the nature of public benefit entities, I consider that NZ IFRS should include guidance to help identify ownership-type transactions in the public sector. I acknowledge that under previous standards similar issues existed. However, the previous Statement of Concepts for General Purpose Financial Reporting better dealt with the matter. I think it is reasonable to expect more guidance in this area, both in the NZ Framework and, where relevant, in standards.

No guidance about significantly influencing an entity without equity instruments

A2.11 NZ IAS 28 addresses the accounting for investments in associates. Associates are entities in which an investor has significant influence, but are not subsidiaries or joint ventures. Significant influence is defined as the power of an investor to participate in the financial and operating policy decisions of an entity, but without control or joint control over those policies.

A2.12 NZ IAS 28 assumes the investor has a defined ownership interest in the associate. The interest is often defined by the number of shares the investor has in the associate. Alternatively, there may be an agreement that establishes an investor's equity contribution and share of profit or loss of the associate, such as in a partnership agreement.

A2.13 In the public sector, there are some public benefit entities that have together established an associate entity without defined ownership interests. Such associate entities typically carry out activities that are consistent with the objectives of the public benefit entities that established them. In my view, the establishing public benefit entities typically have an ownership interest in the associate entity, as that term is explained in NZ IFRS.

A2.14 Usually each of the public benefit entities will be able to appoint people to the body that governs the associate entity. In this way, the public benefit entities can participate in the financial and operating policy decisions and, therefore, have significant influence over the associate entity.

A2.15 I am concerned that NZ IAS 28 provides no guidance to public benefit entities about how to account for an associate entity in the situation described above.

Deficiencies in accounting lead to deficiencies in information for people who use the financial statements. I acknowledge that the point I raise existed in the previous standard. However, I believe it is reasonable that matters such as this one are dealt with by appropriate changes being made to NZ IAS 28.

Unclear whether price indices can be used for certain public sector asset revaluations

A2.16 NZ IAS 16 allows plant and equipment to be valued on the basis of readily available price indices that establish a reliable fair value. The paragraph in NZ IAS 16 that allows use of price indices is very similar to a paragraph in the previous standard, FRS-3. However, FRS-3 also contained further commentary that provided context for the use of price indices. The commentary made it clear that price indices could not be used where depreciated replacement cost was the basis for determining the fair value of plant and equipment.

A2.17 Depreciated replacement cost is often used to arrive at the fair value of assets in the public sector. I am concerned that NZ IAS 16 does not provide context for the use of price indices, particularly where fair value is based on depreciated replacement cost.

A2.18 I am aware that some entities in the public sector are interpreting NZ IAS 16 to mean that price indices can be used for depreciated replacement cost valuations. Those entities note that if the Financial Reporting Standards Board had intended NZ IAS 16 to result in the same treatment as FRS-3, the contextual commentary would have been added to NZ IAS 16.

A2.19 I am not particularly comfortable with price indices being used for depreciated replacement cost valuations, because it means fair value is being derived without the appropriate involvement of an independent valuer. I suspect the exclusion of contextual commentary about the use of prices indices from NZ IAS 16 was an oversight. In my view, NZ IAS 16 needs to be clarified to avoid unintended consequences either way, and to ensure that reliable information is included in financial statements for those people using them.

No guidance about how public benefit entities account for public private partnerships

A2.20 NZ IFRIC 12 is an interpretation that sets out the accounting for public private partnership arrangements by the private sector partner that operates an asset (subject to a service concession arrangement). The interpretation specifically notes that it does not apply to the public sector partner. The reason the interpretation is limited to the private sector is because the interpretation on which NZ IFRIC 12 is based relates only to the operator of the service concession.

A2.21 I am concerned that the scope of NZ IFRIC 12 does not address the accounting requirements for public private partnership arrangements by the public sector partner. By not addressing this possibility, different accounting treatments of such arrangements are more likely to occur, including that neither partner accounts for the assets underlying the partnership. Differences in accounting do not help people using financial statements to understand the public private partnership arrangements.

A2.22 I am aware that the International Public Sector Accounting Standards Board is creating a standard to address accounting by the public sector partner in such arrangements. In my view, when the International Public Sector Accounting Standards Board has created such a standard, it should be used to create a New Zealand standard that sets out the accounting treatment for the public sector partner to these arrangements.

Difficulties assessing the fair value of non-commercial equity investments

A2.23 NZ IAS 39 requires equity investments to be recorded at fair value just like all other financial instruments. Where fair value is not readily attainable, valuation techniques can be used. When fair value cannot be reliably worked out using valuation techniques, the standard allows cost to be used.

A2.24 Fair value for non-commercial equity investments is usually difficult to work out. These difficulties compound when equity investments are in public sector entities that are not traded and not intended to generate net cashflows. In these situations, commercial valuation techniques are likely to be meaningless.

A2.25 I am concerned that NZ IAS 39 does not take into account typical non-commercial equity investments in the public sector. In my view, public benefit entities should not have to default to recording such investments at cost (which is less useful information to most people) simply because a commercial fair value as envisaged by the standard cannot be worked out.

A2.26 I am sure there are other approaches for determining a fair value for such investments. For example, allowing the net assets of the equity investment to be used as a proxy for its fair value. Such a value would be better than cost, particularly where the assets and liabilities of the entity approximate fair value.

Inconsistent accounting for investments received without paying for them

A2.27 In the public sector, it is common for different types of assets to be received by public benefit entities without those entities paying for the assets (or only paying a nominal amount).

A2.28 NZ IAS 16, the standard on property, plant, and equipment, requires property, plant, and equipment received for nil or a nominal amount to be initially recorded at fair value. That requirement relates only to public benefit entities. Standards related to investment assets such as subsidiaries (NZ IAS 27), associates (NZ IAS 28), and joint ventures (NZ IAS 31) do not contain that requirement.

A2.29 Those standards require such investments to be accounted for, either at cost or fair value. Therefore, where there has been nil or a nominal payment, entities are allowed to account for the investment at cost (that is, nil or the nominal amount). In my view, nil or the nominal amount is not particularly relevant for those people using the resulting financial statements.

A2.30 I consider NZ IFRS should be amended for public benefit entities to ensure that accounting for such investments is relevant to people using those entities' financial statements. The amendments should align the accounting for investments received for nil or a nominal amount with the accounting requirements for property, plant, and equipment received for nil or a nominal amount.

Difficulties determining when an entity's investment in a public benefit entity deteriorates

A2.31 NZ IFRS include a standard on impairment (or deterioration in value) of assets (NZ IAS 36). The scope of NZ IAS 36 includes financial assets, such as investments in subsidiaries, associates, and joint ventures.

A2.32 Impairment of investments in subsidiaries, associates, and joint ventures is an important matter for the separate financial statements of a parent entity. Sometimes it can be difficult to work out if there has been impairment. Such difficulties arise where a public benefit entity has investments in subsidiaries, associates, and/or joint ventures that are also public benefit entities.

A2.33 To find out if there has been impairment, the standard requires the recoverable amount of the investment to be worked out. Where an investment is not cash generating, such as investments in public benefit entities, the depreciated replacement cost of the investment is often a proxy for the recoverable amount.

A2.34 A difficulty arises when applying the notion of depreciated replacement cost to investments in public benefit entities. This is because depreciated replacement cost is designed primarily to be used for property, plant, and equipment assets, not all types of assets.

A2.35 I am concerned that the standard is difficult to apply to these types of investments. In my view, the standard should be amended to clarify how depreciated replacement cost can apply to these investments. Alternatively, the standard should use a basis other than depreciated replacement cost for calculating the recoverable amount of these investments.

Unclear whether group financial statements are required when an entity influences but does not control other entities

A2.36 Occasionally in the public sector, an entity will not have any subsidiaries but will have an associate entity or entities. The legislation under which most public sector entities prepare financial statements requires both parent and, where applicable, group financial statements.

A2.37 I find NZ IFRS unclear about whether an entity with no subsidiaries (but with an associate entity) is both a parent entity and, when combined with its associate entity, a group entity. In other words, it is unclear whether the entity needs to prepare both parent and group financial statements. I acknowledge that the point I raise is not limited to the public sector.

A2.38 FRS-38, a previous standard, included helpful guidance for entities with no subsidiaries but with associate entities. That guidance noted that the entity could choose to account for its associate entities in its parent financial statements using the equity method, or it could prepare a separate set of financial statements that used the equity method to account for the associate entities.

A2.39 I do not know why this helpful guidance was not included in NZ IFRS, at least for public benefit entities.

No guidance about how to account for a public sector capital charge

A2.40 NZ IAS 32 requires interest, dividends received, losses, and gains relating to financial instruments to be recognised as income or expense. The standard also requires distributions (such as dividends paid) to holders of an equity instrument to be recognised as a reduction in equity. This means that the classification of a financial instrument as an asset, liability, or equity determines where interest, dividends, losses, and gains are recognised.

A2.41 Capital charges are a cost imposed on many public benefit entities to:

- make transparent the full costs of the goods and services they produce (in particular, costs associated with financing capital); and
- provide information and incentives for efficient management of the Government's investment in public sector entities.

A2.42 Typically, a capital charge is based on an assumed debt-to-equity ratio. However, public sector entities tend not to have either debt instruments or equity instruments, which means the guidance in NZ IAS 32 is not directly helpful.

A2.43 I am concerned that NZ IAS 32 could be interpreted to mean that the capital charge is not an expense of the entity. In my view, reporting the capital charge other than as an expense would thwart the purpose for the charge (that is, to ensure that the costs of capital are included "in the costs of services"), and adversely affect the relevance of financial statements to people using them.

A2.44 I consider NZ IAS 32 needs to explicitly recognise capital charges and provide guidance about how such charges are to be accounted for.

No guidance about accounting for use of Crown-owned property

A2.45 It is reasonably common for a public sector entity to have a right to use or occupy property owned by another entity. For example, state schools have a right to occupy land and buildings owned by the Crown. The arrangements in place between such entities typically are not leases as defined in NZ IAS 17. Also, the standard on intangible assets, NZ IAS 38, is not helpful about how to sensibly account for such arrangements.

A2.46 I am concerned that accounting for these types of arrangements is not adequately addressed in NZ IFRS. In my view, the lack of guidance for these common types of public sector arrangements can lead to inconsistencies in accounting treatment. To remove such inconsistencies throughout the public sector requires effort from my Office. There would not be the need for that effort if NZ IFRS adequately addressed the issue.

A2.47 FRS-3, a previous standard, included helpful guidance about accounting for arrangements where an entity had a right to use or occupy property. The guidance related to such arrangements where the benefits from the right to use or occupy property were substantially the same as if the property were owned. FRS-3 noted that the principles relating to accounting for physical assets, such as property, could be applied to the accounting for these rights.

A2.48 I do not know why this helpful guidance was not included in NZ IFRS for public benefit entities.

Unclear how the Government should account for intangible assets it creates

A2.49 The adoption of NZ IFRS resulted in New Zealand getting a financial reporting standard (NZ IAS 38) that addressed intangible assets. Previously there was not a standard that broadly addressed intangible assets, therefore entities referred to the Statement of Concepts for General Purpose Financial Reporting. NZ IAS 38 includes few changes from IAS 38 for public benefit entities.

A2.50 I am concerned that NZ IAS 38 does not include changes to deal with the type of issues encountered by governments when accounting for intangible assets. Governments establish rights such as fishing quota, radio spectrum licences, and emission trading units. These rights are intangible assets. However, NZ IAS 38 does not address how the Government should account for such rights, including any of those rights that the Government retains and uses.

A2.51 In my view, NZ IAS 38 needs to include requirements and/or guidance to clarify how the Government should account for intangible assets that it establishes, so as to provide relevant information to people using the financial statements of the Government.

Inappropriate accounting for intangible assets received without paying for them

A2.52 Public benefit entities in the public sector commonly receive assets without paying for them (or paying only a nominal amount). Property, plant, and equipment assets received without paying for them, or paying a nominal amount, must be initially recorded at fair value. Intangible assets are another type of asset that can be received for nil or a nominal payment.

A2.53 However, NZ IAS 38 requires all intangible assets to be initially accounted for at cost. Further, it limits the circumstances in which intangible assets can be revalued to such an extent that nearly all such assets cannot be revalued. Where an intangible asset has been received for nil or a nominal payment, I am concerned about the asset being recorded at nil or a nominal amount. In my view, nil or a nominal amount is not particularly relevant information for people using the financial statements.

A2.54 I consider amendments should be made to NZ IAS 38 for public benefit entities to ensure that accounting for intangible assets is relevant to people using financial statements. The amendments should align the accounting of intangible assets received for nil or a nominal amount with the accounting requirements for property, plant, and equipment received for nil or a nominal amount.

Unclear which internally generated intangible assets public benefit entities can recognise

A2.55 NZ IAS 38 outlines the criteria that must be demonstrated before an intangible asset arising from development expenditure can be recognised. Those criteria are also relevant to assessing whether or not website costs can be capitalised, because the criteria are cross-referred to a specific interpretation about website costs (NZ SIC 32).

A2.56 One criteria is that it must be probable the intangible asset will generate future economic benefits. That probability can be demonstrated by the existence of a market for the output of the intangible asset or the intangible asset itself. If the intangible asset is to be used internally, the probability that it will be useful needs to be demonstrated.

A2.57 Although the NZ Framework equates future economic benefits with service potential for public benefit entities, it is open to interpretation whether service potential should be applied to the criteria in NZ IAS 38, and if so, how. In noting this lack of clarity, I am aware that the NZ Framework does not override any specific standard.

A2.58 In my view, changes are needed to NZ IAS 38 for public benefit entities to ensure that accounting for intangible assets is relevant to people using financial statements. The changes need to clarify the application of the notion of service potential as part of the criteria for recognising an intangible asset that arises from development expenditure.

No guidance about common public sector issues with property disposals

A2.59 NZ IFRS 5 has particular accounting requirements for property assets that are for sale. The standard is clear that sales should be expected to be completed within one year, except where delays are beyond the seller's control.

A2.60 In the public sector, property may be disposed of through the Treaty of Waitangi settlements process rather than a sale transaction. That process often takes a long time, so the property may not be disposed of within one year. It is not clear how such property should be dealt with, or indeed whether NZ IFRS 5 is applicable, given disposal of the property is not through sale.

A2.61 NZ IFRS 5 is also prescriptive about the properties that can be considered "for sale". The active marketing of the property is one of the criteria that must be fulfilled for a property to be considered "for sale".

A2.62 In the public sector, it is common for property to be subject to a "disposal of Crown land process" before it can be sold. That process means the property cannot be actively marketed. The process can take a long time, and sometimes more than one year.

A2.63 I am concerned that the processes for both Treaty of Waitangi settlements and disposal of Crown land have not been taken into account in establishing NZ IFRS 5. That standard needs to be amended, or guidance added, to clarify how these common public sector issues are dealt with. In this way, the standard could be clear to those in the public sector who apply it, and lead to relevant information in financial statements for people using them.

Information about managing capital is irrelevant to most public benefit entities

A2.64 NZ IAS 1 requires an entity to disclose information that enables people that use its financial statements to evaluate the entity's objectives, policies, and processes for managing capital.

A2.65 Such disclosures make sense for profit-oriented entities. Those entities typically have share capital, and some are subject to capital requirements such as prudential capital adequacy provisions, or banking covenants.

A2.66 However, I question the value of such disclosures by public benefit entities. As the requirement is currently written, it makes little sense both for those preparing and for those using the financial statements of public benefit entities.

A2.67 Public benefit entities typically do not have equity instruments, or a notion of "capital". A look at some disclosures made by public benefit entities as a result of this requirement generally shows information of no value. I am not surprised, because the requirement has little relevance to public benefit entities.

A2.68 In my view, public benefit entities should be exempted from the disclosure requirement.

Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

- Inland Revenue Department: Managing tax debt
- Electricity Commission: Review of the first five years
- Local government: Results of the 2007/08 audits
- How government departments monitor Crown entities
- Inquiry into immigration matters
- Central government: Results of the 2007/08 audits
- Annual Plan 2009/10
- Workforce planning in Crown Research Institutes
- Performance audits from 2007: Follow-up report
- Department of Corrections: Managing offenders on parole
- Housing New Zealand Corporation: Maintenance of state housing
- Annual Report 2007/08
- Ministry of Health: Monitoring the progress of the Primary Health Care Strategy
- Ministry of Education: Supporting professional development for teachers
- Inquiry into the West Coast Development Trust
- Maintaining and renewing the rail network
- Reporting the progress of defence acquisition projects
- Ministry of Education: Monitoring and supporting school boards of trustees
- Charging fees for public sector goods and services
- The Auditor-General's observations on the quality of performance reporting

Website

All these reports are available in HTML and PDF format on our website – www.oag.govt.nz. They can also be obtained in hard copy on request – reports@oag.govt.nz.

Mailing list for notification of new reports

We offer a facility for people to be notified by email when new reports and public statements are added to our website. The link to this service is in the Publications section of the website.

Sustainable publishing

The Office of the Auditor-General has a policy of sustainable publishing practices. This report is printed on environmentally responsible paper stocks manufactured under the environmental management system ISO 14001 using Elemental Chlorine Free (ECF) pulp sourced from sustainable well-managed forests. Processes for manufacture include use of vegetable-based inks and water-based sealants, with disposal and/or recycling of waste materials according to best business practices.

Office of the Auditor-General
PO Box 3928, Wellington 6140

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

Email: reports@oag.govt.nz
www.oag.govt.nz