Preparing Financial Statements: New Zealand Equivalents to International Financial Reporting Standards

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Contents

Page

1 Introduction 5

1.1 Background to financial reporting disclosure in New Zealand 5

2 New Zealand financial reporting framework 6

2.1 Background 6

2.2 Adopting International Financial Reporting Standards in New Zealand 7

2.3 The New Zealand financial reporting framework 8

2.4 Proposed financial reporting structure 9

3 Objectives of general purpose financial reporting 11

4 The purpose of financial statements 13

5 Legislative requirements underpinning financial reporting in New Zealand 14

5.1 *Financial Reporting Act 1993* 14

5.2 *Companies Act 1993* 17

6 Overall considerations when preparing financial statements 18

6.1 Going concern assumption 18

6.2 Accrual basis 19

6.3 Consistency of presentation 19

6.4 Materiality and aggregation 20

6.5 Offsetting 20

6.6 Comparative information 20

7 Structure and content of general purpose financial reports 21

7.1 General purpose financial reports 21

7.2 General purpose financial statements 22

7.3 Identification of financial statements 23

7.4 Reporting period 23

7.5 Financial statement notes 24

7.6 Disclosure of accounting policies 25

7.7 Other disclosures 29

8 Statement of financial performance 32

8.1 Relationship between an income statement prepared for internal reporting purposes and a statement of financial performance prepared for external reporting purposes 32

8.2 Classification of expenses by nature 34

8.3 Classification of expenses by function 35
8.4 The nature and function method of classifying expenses evaluated 37
8.5 Finance costs 38
8.6 Taxation 39
8.7 Xanadu Limited—a practical example 40
8.8 Statement of financial performance components 41
8.9 Discontinued operations 46
8.10 Directors' remuneration 48
8.11 *Companies Act 1993* disclosure requirements 53
9 Statement of changes in equity 55
10 Statement of financial position 60
10.1 Current assets and liabilities 61
10.2 Assets 64
10.3 Liabilities 81
10.4 Unrecognised contractual commitments 88
10.5 Discontinued operations 89
10.6 Risks and uncertainties 90
11 Equity 90
11.1 Contributed equity 91
11.2 Reserves 92
12 Summary 95

End-of-section question 97
Notes to the 2006 financial statements 100
Review questions 106
Review problems 108
Challenging questions 116
References 123

1 Introduction

This publication details the disclosure requirements for general purpose financial statements prepared by New Zealand companies in accordance with New Zealand equivalents to International Financial Reporting Standards. It commences with a review of the objectives of financial reporting, as it is these that establish the purposes of financial reporting. The legislative requirements contained in the *Financial Reporting Act 1993* and the *Companies Act 1993* are examined to provide the legislative context for financial reporting. The New Zealand financial reporting framework is reviewed to contextualise the structure of financial reporting. Finally, using NZ IAS 1 as the primary source, the disclosure requirements of the statement of financial performance, statement of changes in equity and statement of financial position are examined in detail. The statement of cash flows is not considered in this book as it is covered extensively in an associated text, *New Zealand Financial Accounting 2e*.

In New Zealand, NZ IAS 1 prescribes the basis for presenting general purpose financial statements. Preparing general purpose financial statements that comply with this accounting standard, ensures comparability with those of previous periods, as well as those of other entities. This accounting standard also provides the overall considerations for the presentation of financial statements, guidelines for their structure, and minimum disclosure requirements. It should be emphasised and as is detailed in the illustrations that follow, the disclosure requirements contained in NZ IAS 1 must be supplemented by disclosure requirements found in other accounting standards. As such, this book does not aim to cover all the disclosure requirements contained in the different accounting standards, but rather seeks to illustrate and explain some of more usual disclosures found in a set of financial statements. In addition, the book provides a foundation for further study in more advanced courses.

1.1 Background to financial reporting disclosure in New Zealand

The *Financial Reporting Act 1993* was promulgated in 1993. The result of this was that legislative backing was provided to financial reporting (accounting) standards. In spite of this legislative backing, New Zealand companies continued to be less than forthcoming when disclosing information required by various accounting standards. This position was supported by a study by Lont (1997, p.152) who went on to state that when compared with the United Kingdom and the United States, New Zealand fared poorly when it came to disclosing certain expense categories, including cost of goods sold, staff, distribution and administration expenses. Lont (1997) speculated that reasons for this poor disclosure record included:

- ♦ a tradition of non-disclosure

- imbalance of power between directors and users
- ineffective lobbying and/or court action by shareholders and/or auditors
- tightly held companies (for which external reports are less important)
- lack of education about the effect of non-disclosure.

Lont (1997, p. 159) further argued that this position resulted from managements' reluctance to disclose certain financial information. He speculated further that management justified the non-disclosure, or reluctance to increase existing levels of disclosure on the grounds of:

- the financial costs associated with compiling and producing the information
- commercial sensitivity
- concern about information overload
- perceptions that any additional information provided will be unimportant and could be misinterpreted by users
- the existence of other sources of information
- the threat of increased litigation costs if certain types of information are disclosed.

In an extension of his earlier study, Lont (2002) was able to conclude that since FRS-9 'Information to be Disclosed in Financial Statements' (the predecessor to NZ IAS 1), was introduced in February 1995, there appeared to have been a further decline in the disclosure level of four unspecified expense components (selling, administration, salaries and wages, and cost of goods sold). It appeared to Lont that the wording 'necessary to achieve the objectives of general purpose financial reporting' contained in FRS-9, had been used by preparers of financial statements to circumvent disclosure requirements.

It is clear that although FRS-9 did not permit companies to take a *laissez faire* approach to financial statement disclosure, the wording of the standard did permit some level of flexibility. In supporting this position Lont (2002, p. 88) argued that:

> *While it may have been the intention of the standard setters to allow flexibility in the type of expense disclosure, companies have interpreted FRS-9 to mean that the unspecified expense disclosure is generally not required.*

Lont (2002) went so far to suggest that this 'minimalist interpretation' by companies was effectively condoned by auditors, and supported the contention that auditors no longer applied professional judgement when auditing financial statements, but rather adopted a 'rule-book' approach.

Until the introduction of International Financial Reporting Standards (IFRS) in New Zealand, the only justifiable defence available to companies not wishing to disclose a

category of expense or individual expense item was that it was immaterial and, as such, its disclosure was unnecessary to meet the objectives of general purpose financial reporting. However, it would be difficult to imagine how in the majority of companies, non-disclosure of items such as selling expenses and cost of sales could have been justified on the grounds that these items were not useful to users of the financial statements. Once all entities in New Zealand adopt IFRS, it will be interesting to establish whether the levels of disclosure improve, or whether auditors will continue to issue unqualified audit reports in those circumstances where entities fail to comply fully with the disclosure requirements of the accounting standards.

2 New Zealand financial reporting framework

2.1 Background

At the time of writing, the New Zealand financial reporting framework was undergoing significant transformation. This commenced in 1997, when the Financial Reporting Standards Board (FRSB) decided to pursue a policy of international harmonisation. This process was to result in New Zealand's accounting standards being made compatible with the standards of international standard-setting bodies to the extent that high quality standards resulted. This entailed basing the development of future accounting standards on those issued by the International Accounting Standards Board (IASB) or the Australian Accounting Standards Board (AASB), modified for any unique New Zealand characteristics.

This policy was first trialled in May 1999 with the issue of two exposure drafts based on IASB pronouncements. ED-86 'Provisions, Contingent Liabilities and Contingent Assets', and ED-87 'Accounting for Intangible Assets', were almost verbatim copies of the corresponding IASB standards, except for minor amendments for changes in terminology and format.

At the time, three factors contributed to the decision to adopt these standards as a foundation for the development of future financial reporting standards. These were:

- acknowledgement of the desirability to work towards harmonisation
- recognition of the improved quality of international accounting standards and moves towards harmonisation overseas
- a search for efficiency in developing standards.

Other factors contributing to the decision identified by Hickey and Westwood (2000, p. 83) included 'stakeholder and political heat to harmonise' (although it is uncertain which stakeholder they were referring to), and lobbying by the New Zealand Stock Exchange

(NZSX) to adopt international financial reporting standard rather than developing standards locally. Hickey and Westwood (2000) go so far as to suggest increased funding provided by the Ministry of Commerce for standard-setting activities would have been conditional on appropriate overseas standards (such as those of Australia and the IASB) being adopted.

Various claims of the potential benefits accruing to New Zealand companies from the international harmonisation process have been made. Among other things these include:

- improving the quality of financial reporting in New Zealand
- increasing the comparability of financial reports prepared in different countries and providing participants in international capital markets with better quality information on which to base investment and credit decisions
- removing barriers to international capital flows by reducing differences in financial reporting requirements for participants in international capital markets
- reducing financial reporting costs for New Zealand multinational companies and foreign companies operating in New Zealand and reporting elsewhere
- facilitating more meaningful comparisons of the financial performance and financial position of New Zealand and foreign public sector reporting entities (ED-92 'Preface to Financial Reporting Standards', paragraph 5.8).

The view that harmonisation leads to cost reductions and capital inflows into New Zealand is not one that is necessarily supported (or rejected) by any empirical data. However, the New Zealand Stock Exchange (NZSX) nevertheless holds the view that general compliance with IASB standards will lead to significant additional inflows of foreign investment. In this regard, the International Organizations of Securities Organisations (IOSCO) has contributed funds towards the development of a set of international standards for international stock exchange listings. In May 2001, the IOSCO announced that it would recommend the adoption of IASB standards as a permissible basis for preparation of financial statements to member exchanges throughout the world. Such a move would mean that entities seeking to list its shares on another country's exchange would not need to adjust its financial statements to comply with that country's requirements, as they would already comply with IASB standards.

2.2 Adopting International Financial Reporting Standards in New Zealand

In July 2002, the Financial Reporting Council (FRC) in Australia announced that from January 2005, international financial reporting standards would be adopted in Australia. This caused the New Zealand Accounting Standards Review Board (ASRB) to review its harmonisation policy initially spelt out in ED-92 'Preface to Financial Reporting Standards',

issued in June 2002. This culminated in the October 2002 recommendation by the ASRB to the New Zealand government and other affected bodies that from 2007 listed issuers should comply with International Financial Reporting Standards (IFRS) issued by the IASB. An allowance was made for issuers to adopt IFRS from 2005 if they so wished. This recommendation departs from that made by the FRSB in ED-92, issued in June 2002, to the effect that financial reporting standards would be developed from international standards and that departures from these would only be made in rare and exceptional circumstances. No departures would now be permitted.

The ASRB justified their change in direction and recommendation to government on the grounds that New Zealand's close economic ties with Australia resulted in a tendency for international investors to group New Zealand and Australia together. Failure by New Zealand to follow the Australian lead could prove costly, and place the credibility of New Zealand's financial reporting at risk. After due process, including the issue of exposure drafts, the platform of New Zealand Equivalents to International Financial Reporting Standards (NZ IFRS) was approved by the ASRB on 24 November 2004.

2.3 The New Zealand financial reporting framework

At the time the decision was taken to adopt international financial reporting standards, a number of documents made up the New Zealand financial reporting framework. These were:

- 'Statement of Concepts for General Purpose Financial Reporting'
- 'Framework for Differential Reporting'
- 'Explanatory Foreword to General Purpose Financial Reporting'
- FRS-1 'Disclosure of Accounting Policies'
- FRS-2 'Presentation of Financial Reports'.

At the time of writing a number of the documents in the financial reporting framework had been, or were in the process of, being replaced by New Zealand equivalents of international financial reporting standards. For example, FRS-2 has been replaced by NZ IAS 1, while FRS-1 has been superseded by NZ IAS 8. More recently, the FRSB issued an 'Exposure Draft of the New Zealand Framework (NZ Framework)' which will supersede the 'Statement of Concepts' issued in 1993 and revised in November 2001, while the proposed 'NZ Preface' will supersede the 'Explanatory Foreword to General Purpose Financial Reporting (Explanatory Foreword)' issued January 1995. Work is currently being undertaken on a replacement for the 'Framework for Differential Reporting', with an exposure draft, ED-98, 'Framework for Differential Reporting for Entities Applying the New Zealand Equivalents to

International Financial Reporting Standards Reporting Regime', issued for comment by the FRSB in December 2004.

NZ IAS 1 establishes a framework for the information to be presented or displayed in general purpose financial statements and deals with the disclosure of accounting policies. The selection of accounting policies considered most appropriate to an entity is dealt with by NZ IAS 8, which also details the information to be disclosed when a change in accounting policy occurs. In addition, it is important to remember that other New Zealand equivalents of international financial reporting standards detail that specific information that must be disclosed in financial statements. Finally, section 211 of the *Companies Act 1993* is significant for financial reporting purposes as it provides details of additional information that should be disclosed.

2.4 Proposed financial reporting structure

Following the decision to adopt IFRS, the ASRB proposed a new financial reporting structure. This review proposed to include all entities in the private and public sector, including companies, partnerships, trusts and sole traders. In other words, widen the net with regard to the types of entities potentially subject to legal requirements of financial reporting. However, in line with the cost/benefit test, proposed higher thresholds before entities became subject to legal reporting requirements would mean that many smaller entities would obtain relief from their reporting requirements currently in place.

The FRSB considered the 'reporting entity' concept to be the most appropriate for New Zealand circumstances. Under this concept (which is consistent with that adopted in Australia) an entity is considered to be a reporting entity where there are external users dependent on general purpose financial statements for making and evaluating resource allocation decisions. This means that where a reporting entity is required to prepare financial statements it should comply fully with generally accepted accounting practice.

Because of the difficulties associated with identifying and measuring costs and benefits associated with financial reporting, the proposed structure makes use of a number of proxies to categorise entities into three groups. Tiers 1 and 2 cover reporting entities, while tier 3 covers non-reporting entities. The proxies cover a number of dimensions namely, issuer, power to levy taxes or rates, responsibility to report, and size (Hickey & van Zijl, 2003, p. 54). Each of these proxies is dealt with below.

Under the proposed structure, the term issuer (considered in further detail in section 5.1 below) has the same meaning as currently given under the FRA. According to Hickey and van Zijl, (2003, p. 54), an entity has reporting responsibilities where:

- *The constitution of the entity of governing legislation requires the entity to account to the public (eg, a requirement to file with an appropriate registrar), or*
- *The office holders are accountable to the general public, or*
- *The elected officers are like trustees in their stewardship (eg, clubs, member-owned entities), or*
- *The entity has a charitable purpose (as approved by Inland Revenue), or*
- *There is 'foreign ownership' as defined by the Financial Reporting Act 1993, or*
- *There is separation of ownership and management.*

Under the size test, an entity will be considered large if it exceeds any two of the following criteria:

- total income of $20 million
- total assets of $10 million
- more than 50 full-time equivalent employees (ED-98).

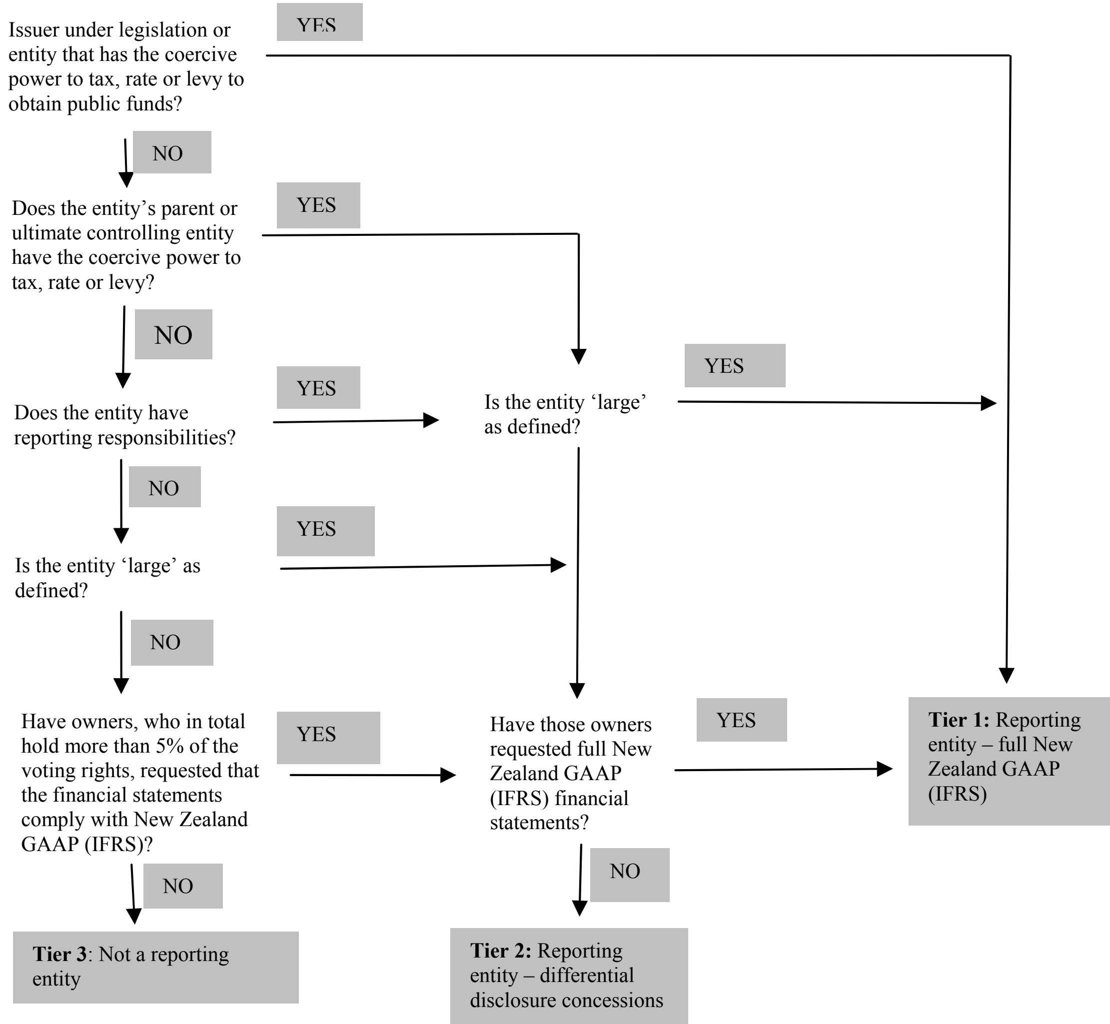
Table 1 details the proxies for costs and benefits used to categorise entities into the three different groups, while Figure 1 (page 11), illustrates the financial reporting structure for all entities.

Table 1 Costs and benefits used to categorise entities

Tier 1	Tier 2	Tier 3
Reporting entities – full New Zealand GAAP (IFRS) Issuers ♦ Entities that have a coercive power to tax, rate or levy (the Crown and local authorities) ♦ Large entities in the public sector ♦ Large entities with reporting responsibilities ♦ Entities where 5% or more of the owners request financial statements that comply with full GAAP	Reporting entities – differential disclosure concessions Small public sector entities whose owners have not requested compliance with full GAAP ♦ Small entities with reporting responsibilities where a specified proportion of owners have not requested compliance with full GAAP ♦ Entities (which are otherwise in tier 3) where 5% or more of the owners request financial statement that comply with differential GAAP	Not a reporting entity Free of any legal reporting requirements.

As Tier 2 entities are likely to be able to make use of differential reporting requirements, this publication focuses on the disclosure requirements of Tier 1 entities.

Figure 1 Financial reporting structure



Source: Hickey, L. & van Zijl, T. 2003.

3 Objectives of general purpose financial reporting

Before any examination of financial statement disclosure is commenced, it is necessary to review the objectives of general purpose financial reporting since it is these objectives that establish the purpose of accounting and define its boundaries (Buzby 1982, p. 650). A commonly accepted objective of financial reporting is the provision of relevant information to users for the purposes of making economic decisions. In the Statement of Financial Accounting Concepts 1 (SFAC1), the USA Financial Accounting Standards Board (FASB) describes an objective of financial reporting as the provision 'of information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions'. In focusing on the objective 'rational decision' Deegan (2000, p. 141) argues that the FASB has adopted a neo-classical perspective. This is based on the premise that 'in line with [neo-classical] economic and [positive] accounting literature, a

rational decision is one that maximises utility, with this utility typically considered to be related to the maximisation of wealth' (words in square parenthesis inserted).

This neo-classical objective of general purpose financial reporting described earlier, is also contained in the New Zealand Framework (NZ Framework) and its predecessor, the 'Statement of Concepts for General Purpose Financial Reporting' (Statement of Concepts). The NZ Framework paragraph 12, states that:

> *The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.*

Although it could be argued that the objectives in this statement appear rather innocuous and generalised, they are consistent with those previously contained in the Statement of Concepts. The NZ Framework suggests that financial statements show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. This enables users, including present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the public, to assess the stewardship or accountability of management so that they can make more informed economic decisions, including whether to hold or sell their investment in the entity, or to reappoint or replace the management.

The NZ Framework (paragraphs 15–20) states that when making economic decisions, users base their evaluation of the entity's ability to generate cash and cash equivalents, as well as the timing and certainty of any cash generated. To achieve, information on the financial position (provided by the statement of financial performance), financial performance (provided by the statement of financial performance) and change in financial position (provided by the cash flow statement), is required. Although each statement provides different information, the NZ Framework (paragraph 20) emphasises that the interrelationship between them means that a single statement is unlikely to provide the information necessary for the needs of a particular user.

Once users of financial information have been identified, user-group characteristics can be identified, which in turn determine the type of information required and the form of its presentation. From this it is reasonable to assume that different users have vastly differing needs and different degrees of access to this information. Certain parties with an interest in the financial affairs of an entity might be in a position to successfully demand reports that meet their information needs. For example, where a company that is short of funds for expansion approaches a bank for a loan, the bank is in a position to demand all the

information it requires in order for it to make the loan decision. (The company also has a strong incentive to supply that information.) Other parties, for example a creditor who has supplied goods on credit, does not have the same power as the bank, and consequently must rely on reports of a more general nature released by the reporting entity for their information requirements. These are known as general purpose financial statements. Examples include the financial statements and supporting notes and documentation presented in the form of an annual report to shareholders at a general meeting.

Financial reporting has an accountability and an information or decision-making role. Accountability can be described as where one party requires another to account to another for performance over a period. For example, the directors of a company are accountable to shareholders at the end of each reporting period in accordance with the notion of stewardship. Decision usefulness is the provision of information to satisfy the information needs of a wide range of general purpose financial statement users. The relative importance of these roles can vary for different users in different sectors. From this it can be established that the provision of financial and non-financial information is necessary to meet the accountability and information objectives of all users of general purpose financial statements.

4 The purpose of financial statements

The purpose of financial statements is to provide a structured representation of the financial position and financial performance of an entity. What this means is that where financial statements have been prepared in accordance with NZ IAS 1, the information provided about the entity's financial performance, financial position and cash flows assists users in making economic decisions, as well as detailing the results of management's stewardship of the resources entrusted to it. Preparing financial statements in accordance with NZ IAS 1 also assists entities to comply with relevant legislation, regulations, common law and contractual arrangements. Financial statements provide information about an entity's:

- assets
- liabilities
- equity
- income and expenses, including gains and losses
- other changes in equity
- cash flows.

This information, together with that contained in the accompanying notes, assists users in predicting the timing and certainty of an entity's future cash flows. Users are then able to

value the entity by discounting the future cash flows at rates which compensates them for any risks or uncertainties involved.

5 Legislative requirements underpinning financial reporting in New Zealand

Before the general purpose financial report disclosure requirements are examined in any detail, it is necessary to review the legislative requirements surrounding financial reporting to establish the *legislative* context within which financial reporting takes place in New Zealand.

Financial reporting in New Zealand is underpinned by two pieces of legislation: the *Financial Reporting Act 1993* (FRA) and the *Companies Act 1993*. These pieces of legislation differ in two main respects. The FRA details the overall financial reporting framework, while the *Companies Act 1993* provides for the administrative requirements. Limited disclosure requirements are also contained in the *Companies Act 1993*.

5.1 Financial Reporting Act 1993

The FRA applies to all entities. Section 2 of the FRA defines an entity as a company or any issuer. According to section 4 of the FRA an issuer is any party who has made a public issue of debt or equity securities. The term 'issuer' is therefore very broad and includes:

- entities that have allocated securities either by way of an investment statement or a registered prospectus to the public
- entities that have securities quoted on the New Zealand Exchange
- life insurance companies that have issued any life insurance policies according to an offer of securities to the public
- unit trusts in which securities have been allocated according to an offer of securities to the public
- registered banks that have allocated securities to the public.

Issuers therefore include companies, building societies, industrial and provincial societies, friendly societies, credit unions, and incorporated societies, as well as unincorporated bodies, trusts or organisations such as retirement villages, and individuals. Excluded from the definition of 'issuer' are the Crown, local authorities and superannuation schemes. Companies with fewer than twenty-five shareholders are also excluded, unless they are classified an issuer for some other reason.

Directors of every reporting entity have an obligation to ensure that within five months of the balance date, financial statements that comply with section 11 of the FRA are completed, dated and signed on behalf of the directors by two directors, or the sole director

(section 10, FRA). Section 11(1) requires the financial statements to comply with generally accepted accounting practice (GAAP).

5.1.1 Generally accepted accounting practice

GAAP is described in the 'New Zealand Preface' (Preface), paragraph 8, as 'the term used to describe the basis on which general purpose financial statements are prepared'. This includes the specific rules, practices and procedures relating to particular circumstances, together with the broad concepts and principles of general application. The importance of GAAP in the preparation of financial reports is recognised by the legislative requirements contained in the FRA. In terms of section 3 of the FRA, financial statements and group financial statements comply with GAAP only if they comply with applicable financial reporting standards.

Accounting standards are the primary indicators of GAAP. For an entity to comply with GAAP, it must adhere to all applicable financial reporting standards. If a particular situation is not covered by an accounting standard (or where there is no applicable rule or law), the accounting policies of the entity should be appropriate to the circumstances, and have authoritative support within the accounting profession in New Zealand.

In New Zealand, the Accounting Standards Review Board (ASRB) has the authority to direct which accounting policies have authoritative support within the accounting profession. Where a transaction, other event or condition is not dealt with by an accounting standard or an interpretation of a standard, management must use their judgement in developing an appropriate policy. Central to the development of the accounting policy is that is must result in information that is relevant to the economic decision making requirements of users, and be reliable (Preface, paragraph 30). This requirement is reinforced by NZ IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', paragraph 10, which states that:

> *In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:*
> *(a) relevant to the economic decision-making needs of users; and*
> *(b) reliable, in that the financial statements:*
> *(i) represent faithfully the financial position, financial performance and cash flows of the entity;*
> *(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;*
> *(iii) are neutral, ie free from bias;*
> *(iv) are prudent; and*
> *(v) are complete in all material respects.*

The process to be followed in the development of an appropriate policy is detailed in the Preface, paragraph 30, and NZ IAS 8, paragraph 11, both of which require management to

adopt a hierarchical approach. In using their judgement, management should refer to, and consider the applicability of, in descending order, the following sources:

> *the requirements and guidance in Standards and Interpretations dealing with similar and related issues; and*
>
> *(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the NZ Framework* (Preface, paragraph 30 and NZ IAS 8, paragraph 11).

In making a decision, consideration should also be given to the most recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices. However, care should be taken to ensure that these sources do not conflict with the requirements of NZ IAS 8, paragraph 11, considered above.

'The Preface' (paragraph 33) suggests that Technical Practice Aids issued by the FRSB would be an example of a pronouncement of a standard setting body that could be used as a source of guidance in developing and applying accounting policies. Examples of well-recognised bodies with the authority to promulgate reporting standards and which make use of a similar conceptual framework include bodies such as those established in the United Kingdom, Canada and the United States of America.

Professional judgment should be used to resolve conflicts between sources of authoritative support when determining what constitutes GAAP. Professional judgment must also be exercised where authoritative support might be affected by the absence of or incomplete due process.

5.1.2 Composition of financial statements

The composition of financial statements and group financial statements is considered in sections 8(1) and 9(1) of the FRA. Financial and group financial statements comprise a statement of financial position, statement of financial performance, a profit and loss account for entities not trading for profit, a revenue and appropriation account for building societies, a cash-flow statement and appropriate accompanying explanatory notes.

5.1.3 The fair presentation override

NZ IAS 1 places a strong emphasis on fair presentation. Paragraph 13 requires financial statements to present fairly the financial position, financial performance and cash flows of an entity. In this context, fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the NZ Framework. In emphasising the importance of compliance with IFRS, NZIAS 1, paragraph 14, requires

entities to make an 'explicit and unreserved statement' that they comply with IFRS requirements. Financial statements cannot be described as being in compliance with IFRS unless all IFRS requirements are complied with, meaning then a true and fair view is unlikely to be presented.

General purpose financial statements of New Zealand entities only achieve fair presentation in circumstances where they have been prepared in compliance with the requirement of the New Zealand equivalents to IFRS, as well as providing any additional disclosure necessary to ensure fair presentation is achieved. This is achieved according to NZ IAS 1, paragraph 15, by:

- the selection and application of accounting policies in accordance with NZ IAS 8
- presenting information, including accounting policies, in such a way that relevant, reliable, comparable and understandable information is provided
- providing sufficient additional disclosures when compliance with the specific requirements in New Zealand equivalents to IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

5.1.4 The true and fair view

Under the FRA, compliance with GAAP usually means that financial statements should provide a true and fair view of an entity's financial position, performance and cash flows. In circumstances where compliance with GAAP does not result in a true and fair view, section 11 of the FRA requires that the directors provide additional information and explanations in order to ensure that the financial statements provide a 'true and fair' view. As will be discussed later, NZ IAS 1, paragraph 21, requires management to provide additional information in those rare circumstances where they, management, conclude that compliance with an IFRS requirement is misleading.

5.2 Companies Act 1993

The *Companies Act 1993* is applicable to all companies. As such it has a narrower focus than the FRA, which applies to all companies and all issuers. As indicated earlier, the *Companies Act 1993* details administrative and limited disclosure requirements.

5.2.1 Administrative provisions

The administrative requirements applicable to financial statement disclosure are contained in sections 208 and 209. Under section 208, the board of every company is required, within five months of the balance date, to prepare an annual report on the affairs of the company. The annual report should be sent to every shareholder no fewer than twenty working days before

the date fixed for holding the annual meeting (section 209(1)), unless the shareholder has waived their right (in writing) to receive a copy of the report. The report must, however, be available for inspection by shareholders. Copies of the financial statements (and group financial statements) must be sent to all shareholders that have waived their right to the annual report (section 210).

5.2.2 Statutory disclosure provisions

Section 211 of the *Companies Act 1993* details the content requirements of annual reports. The overriding consideration is stated by section 211(1), which requires annual reports to be in writing and dated. In addition the report should include completed and signed (on behalf of the board by two directors or the sole director) financial statements that comply with the provisions of the FRA, and an auditor's report. Unless all shareholders have agreed otherwise, the annual report must disclose the items contained in section 211. Further details of the *Companies Act 1993* disclosure requirements are provided in section 8.11.

6 Overall considerations when preparing financial statements

A number of issues need to be considered when preparing a set of financial statements. NZ IAS 1 details these as follows: fair presentation and compliance with IFRS; going concern; accrual basis of accounting; consistency of presentation; materiality and aggregation; offsetting; and comparative information. The fair presentation and compliance with IFRS has been considered in relation to the contribution it makes to the true and fair value so is not considered further here. A summary of the remaining items is presented below.

6.1 Going concern assumption

Financial statements are generally prepared on the assumption that the entity is a going concern. This assumes that the entity will continue to operate in the foreseeable future and that there is neither the intention nor the need, to liquidate or curtail materially, the scale of its operations. NZ IAS 1, paragraph 23, recognises this assumption and requires management to assess the entity's ability to continue as a going concern when preparing financial statements. All material uncertainties relating to events or conditions likely to impact upon the entity's ability to continue as a going concern should be reviewed. This must take into account all available information and not merely be limited to the twelve month period from the balance sheet date.

Whether an entity can be considered a going concern depends on individual circumstances. For example, previously profitable entities with ready access to financial resources are likely to be able to continue as a going concern. Other factors management

would consider in determining whether the going concern assumption remains appropriate includes information on the entities:

- current and expected profitability;
- future debt repayment schedules
- potential sources of replacement financing.

If management intends to liquidate the entity or cease trading, the going concern assumption is no longer appropriate. Financial statements are then prepared on some other basis. In these circumstances, management is required to disclose the basis on which the financial statements have been prepared, together with the reasons why the entity is no longer regarded as a going concern (NZ IAS 1, paragraph 23).

6.2 Accrual basis

NZ IAS 1, paragraph 25, requires entities to prepare their financial statements (other than cash flow statements) using the accrual basis of accounting. Under the accrual basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent, is received or paid). Transactions and other events are recorded in the accounting records and reported in the financial statements of the periods to which they relate. The accrual basis of accounting contributes to financial statements meeting their objectives by, as the NZ Framework, paragraph 22 states, informing

> *users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.*

6.3 Consistency of presentation

The presentation and classification of items in financial statements should be retained from one period to the next. There are however, two situations identified by NZ IAS 1, paragraph 27, where changes to presentation or classification may occur. These include a significant change in the nature of the entity's operations or a review of its financial statements. Should this situation arise, management may, after taking into account the requirements of NZ IAS 8, believe another presentation or classification to be more appropriate. The second situation identified by NZ IAS 1 where the presentation and classification of items in financial statements may occur is if an accounting standard or interpretation requires a change in presentation.

6.4 Materiality and aggregation

Financial statements result from the processing and combination of a significant number of transactions or other events. These are then aggregated into classes according to their nature or function before being disclosed as individual line items in the financial statements. NZ IAS 1, paragraph 29, requires each material class of similar items to be separately disclosed in the financial statements. Dissimilar items may be aggregated only if they are not individually material. NZ IAS 1, paragraph 30, does however caution that although an item may not be material enough to warrant separate presentation on the face of individual financial statements, for example in the statement of financial position, its disclosure in the accompanying notes may be warranted.

6.5 Offsetting

Assets and liabilities, and income and expenses, are not to be offset unless required or permitted by an IFRS or interpretation (NZ IAS 1, paragraph 32). The reason for this is that offsetting may impact upon users understanding of the underlying transaction, event or condition that occurred, thereby reducing their ability to assess the entity's future cash flows.

The measurement of assets net of valuation allowances, for example reducing the amount of accounts receivable by the provision for bad debts, does not amount to offsetting. Furthermore, deducting the proceeds on disposal of an item of property plant and equipment from its carrying value and disclosing the profit or loss, also does not amount to offsetting. Rather this reflects the substance of the transaction.

6.6 Comparative information

Comparative information in respect of the previous period must be provided for all amounts shown in the financial statements. It is important for preparers of financial statements to appreciate that this is not limited to numeric amounts only. As NZ IAS 1, paragraph 36, states:

> *Comparative information shall be included for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.*

This is especially appropriate when the narrative information provided in the previous year continues to be relevant in the current year. For example, if an outcome to a legal matter was under dispute, and its outcome was reported as being uncertain in the previous financial year, the steps taken in the current year to resolve the dispute should be disclosed in the financial statement notes.

Specific disclosures should also be made when a decision is made to reclassify or change the presentation of individual items in financial statements. Where this occurs, the comparative amounts must also be reclassified. Reclassification of a financial statement item requires an entity to disclose the amount of the reclassification, the amount of each item or class of item that is reclassified, and the reason for the reclassification (NZ IAS 1, paragraph 38).

However, an entity is not required to reclassify a comparative item where it is considered impracticable to do so. Where exist to make the reclassification of a comparative items impracticable, paragraph 39 requires the entity to disclose the reasons for not reclassifying the amount as well as the nature of the adjustments that would have been made if the amounts had been reclassified.

Care should be taken to ensure that entities do not justify the non disclosure of reclassified items on the grounds of impracticability. It is submitted that in most modern entities where detailed accounting records are maintained, the information exists or is relatively available to ensure that the necessary reclassification of comparative figures can occur.

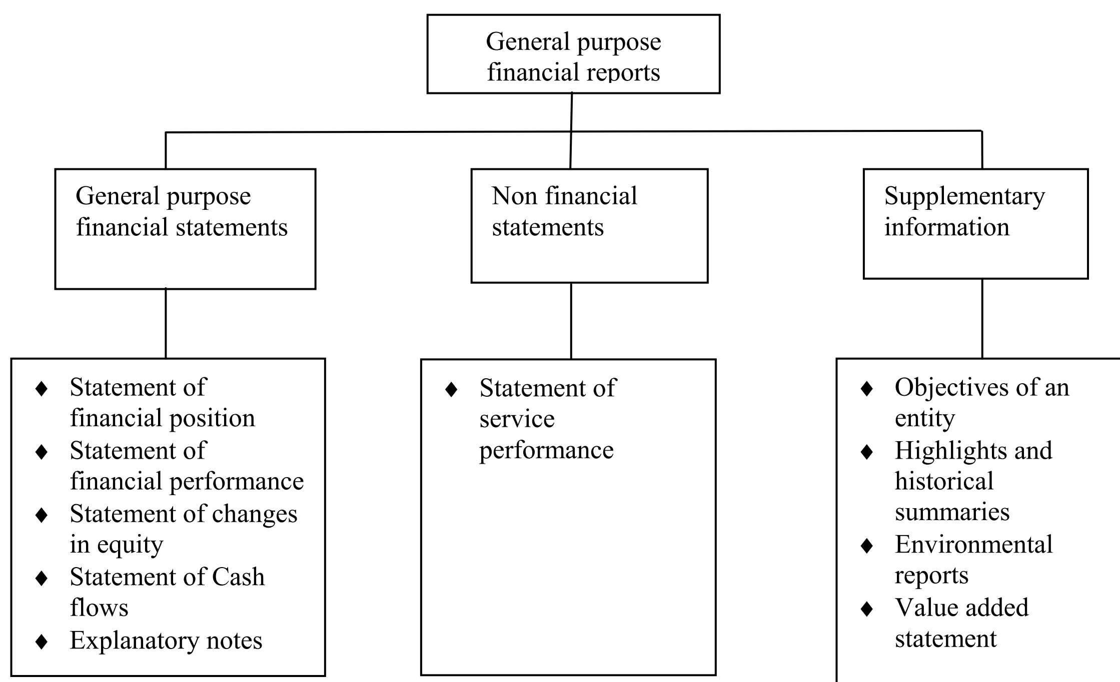
7 Structure and content of general purpose financial reports

7.1 General purpose financial reports

The relationship between general purpose financial reports and general purpose financial statements is simple to understand, and is shown diagrammatically in Figure 2. General purpose financial reports comprise general purpose financial statements, non-financial statements and supplementary information that is additional to the information in financial and non-financial statements.

Where the reporting of non-financial performance is important, for example by municipalities, this can best be achieved by providing a statement of service performance, together with appropriate accounting policies and explanatory notes. Supplementary information provided in general purpose financial reports is information, financial or non-financial in nature, which provides details additional to those contained in the financial report. It includes any additional information required by legislation, highlights and historical summaries, and environmental and sustainability reports.

Figure 2 Diagrammatic representation of the composition of general purpose financial reports



Source: FRS-2, 1994

7.2 General purpose financial statements

General purpose financial statements are designed to meet the information needs of external users who are unable to require or contract for the preparation of special purpose financial statements. General purpose financial statements referred to in NZ IAS 1, include (paragraph 8):

- *(a) a balance sheet;*
- *(b) an income statement;*
- *(c) a statement of changes in equity showing either:*
  - *(i) all changes in equity, or*
  - *(ii) changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders;*
- *(d) a cash flow statement; and*
- *(e) notes, comprising a summary of significant accounting policies and other explanatory notes.*

These requirements are consistent with those contained in sections 8(1) and 9(1) of the FRA.

NZ IAS 1 sets out the overall framework and responsibilities for the preparation of financial statements. In addition, the requirements for the presentation of financial statements is set out, guidelines for their structure and the minimum disclosure requirements for the statement of financial position, statement of financial performance and presentation of

changes in equity is provided. Also described are those additional items that may be presented either on the face of the relevant financial statement or in the notes.

The 'Guidance on Implementing IAS 1' which accompanies NZ IAS 1, but does not form part of the standard, provides illustrations of the statement of financial position, statement of financial performance and presentation of changes in equity. While these formats are appropriate and comply with the requirements of NZ IAS 1, other formats may be equally appropriate. Ultimately, the format chosen for financial statements will depend on individual circumstances.

7.3 Identification of financial statements

As can be been in Figure 2, general purpose financial statements are made up of a number of different statements, all of which contain information useful to users. In order for users to be able to distinguish between that information prepared in compliance with IFRSs and other information, NZ IAS 1, paragraph 44 requires that the financial statements be clearly identified and 'distinguished from other information in the same published document'.

The identification of components of financial statements requires further additional disclosures which should be prominently displayed including:

- the name of the entity reporting and any changes in its name since the last balance sheet date
- whether the financial statements cover the entity or a group of entities
- the balance sheet date or period covered by the financial statements
- the presentation currency
- the level of reporting precision (dollars, thousands or millions of dollars).

These disclosures usually take place on the face of the individual financial statements.

7.4 Reporting period

NZ IAS 1, paragraph 49 requires entities to present financial statements on an annual basis. Where an entity changes its balance sheet date, the annual financial statements will in the year of the change, be presented for a period longer or shorter than a year. Where this occurs the entity must disclose:

- the reason for using a longer or shorter period
- the fact that comparative amounts for the income statement, statement of changes in equity, cash flow statement and related notes are not entirely comparable (NZ IAS 1, paragraph 49).

7.5 Financial statement notes

Notes to financial statements are integral to the financial reporting process. The wording, which should be clear and unambiguous, provides additional explanatory and background information on the composition of the figures disclosed as line items in the individual financial statements. Additionally, notes provide information on risks and uncertainties affecting the entity, as well as those resources and obligations not recognised in the statement of financial position. It is important to appreciate that notes should not be limited to providing information about past transactions and events. Information of a historical nature may be supplemented by interpretative comments on the financial information while prospective information may also be provided.

The NZ Framework (paragraph 21.2), recommends that where interpretive comments are provided, these should focus on the relationships between material changes in financial elements and the entity's history, current activities, external environment or objectives. Prospective information may be either narrative or quantitative. Narrative information should be sufficient to permit users to assess an entity's prospects with its focus on how anticipated changes in the economic environment are likely to affect results, liquidity and risk. Quantitative information based on assumptions about future economic conditions and course of action, can take the form of predictive results for operations, financial position and cash flows (NZ Framework, paragraph 21.3).

Notes (to financial and non-financial information) must amplify or explain components of the financial statements or provide additional information about a particular transaction or event. For example, where investments are reflected in the statement of financial position at historical cost, their market value might be provided in a note. Notes may also contain information about an entity, its activities and its relationship with other entities, including but not limited to, information about segmental data, cost of services, transactions with related parties and so forth.

NZ IAS 1 provides detailed information on the form financial statement notes should take. The overriding requirement is provided in paragraph 103 which requires notes to:

(a) present information about the basis of preparation of the financial statements and the specific accounting policies used in accordance with paragraphs 108-115;

(b) disclose the information required by New Zealand equivalents to IFRSs that is not presented on the face of the balance sheet, income statement, statement of changes in equity or cash flow statement; and

(c) provide additional information that is not presented on the face of the balance sheet, income statement, statement of changes in equity or cash flow statement, but is relevant to an understanding of any of them.

Notes should be provided in a systematic manner, with each item on the face of the balance sheet, income statement, statement of changes in equity and cash flow statement being cross referenced to any related note. Notes should be provided in a specific order. These are detailed in NZ IAS 1, paragraph 105, as:

(a) a statement of compliance with IFRSs (see paragraph 14);
(b) a summary of significant accounting policies applied (see paragraph 108);
(c) supporting information for items presented on the face of the balance sheet, income statement, statement of changes in equity and cash flow statement, in the order in which each statement and each line item is presented; and
(d) other disclosures, including:
(i) contingent liabilities (see NZ IAS 37) and unrecognised contractual commitments; and
(ii) non-financial disclosures, eg the entity's financial risk management objectives and policies (see NZ IAS 32).

Where financial statements are prepared in New Zealand, the entity is required to provide a statement of compliance with NZ GAAP prior to the information presented above. Notes providing information concerning the basis of preparation and the specific accounting policies may be presented as separate components of the financial statements.

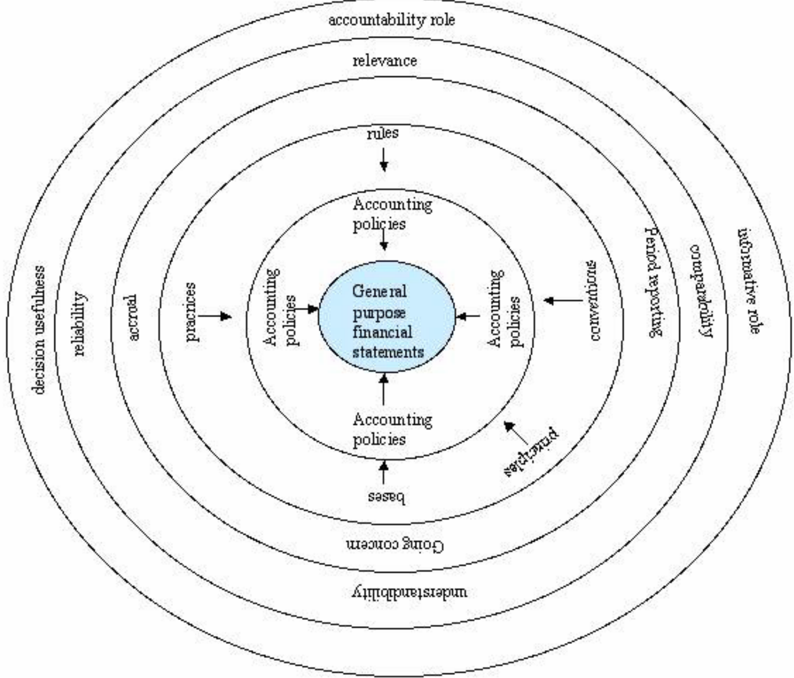
7.6 Disclosure of accounting policies

As indicated earlier, an integral component of financial statements is the summary of significant accounting policies. Two accounting standards need to be considered here, NZ IAS 1, and NZ IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'. While NZ IAS 1 deals with the disclosure of the accounting policy notes, NZ IAS 8 deals with the selection and disclosure of appropriate accounting polices, as well as changes in accounting policies.

7.6.1 Accounting policies and concepts reviewed

Accounting policies are defined in NZ IAS 8, paragraph 5, as the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. Diagrammatically, accounting policies can be seen as evolving from specific principles, bases, conventions, rules and practices which have evolved from accounting concepts. This relationship is illustrated in Figure 3.

Figure 3 Relationship between accounting policies, accounting bases, rules and procedures and accounting concepts



Accounting concepts are the broad general assumptions that underlie the periodic financial statements of business enterprises. These are identified in the NZ Framework and NZ IAS 1 as the going-concern, period-reporting and accrual-basis assumptions. Accounting concepts are dealt with in more detail in Chapter 1 of the accompanying text, *New Zealand Financial Accounting 2e.* While the use of these concepts might not necessarily be self-evident from an examination of financial statements, they have such general acceptance that their explanation is unnecessary, and their observance is presumed unless otherwise stated. Where these assumptions have not been used in the preparation of the financial statements, and this has a material effect, the reasons for not applying the assumptions must be provided.

Accounting principles, bases, conventions, rules and practices are the methods that have been developed for expressing or applying accounting concepts to financial transactions and events. By their nature, accounting principles, bases, conventions, rules and practices are more diverse and numerous than accounting concepts, since they have evolved in response to the variety and complexity of types of businesses and business transactions. For this reason there might be more than one recognised accounting principles, bases, conventions, rules and practices that can be used for dealing with a particular item.

For example, different accounting principles, bases, conventions, rules and practices can be recognised for items such as:

- ♦ inventory and work in progress
- ♦ depreciation of fixed assets and amortisation of intangible assets
- ♦ long-term contracts.

This list is not exhaustive and will vary according to the nature of the operation conducted by the entity. Because of the numerous accounting principles, bases, conventions, rules and practices available to an entity, disclosing the accounting policy adopted for the purposes of preparing financial statements is necessary for users to obtain a complete understanding of the financial statements and to ensure that inter-period and inter-entity comparison can occur. Taking inventory as an example, an appropriate accounting policy for inventory would be inventory valued at the lower of cost and net realisable value on a first-in first-out basis. While this is the only method permitted for valuing inventory, cost can be determined in a number of ways, for example actual cost or average cost. Devonport and McNally (1998, p. 49) consider that while some accounting principles, bases, conventions, rules and practices adopted in preparing financial statements are more basic than others, some are merely a method of applying a base.

7.6.2 Selecting an accounting policy

The choice of an accounting policy can significantly affect the financial and service performance, financial position and cash flows presented by an entity in its financial statements. An entity should according to NZ IAS 8, paragraph 10, select an accounting policy that results in information that is:

> *(a) relevant to the economic decision-making needs of users; and*
> *(b) reliable, in that the financial statements:*
> *(i) represent faithfully the financial position, financial performance and cash flows of the entity;*
> *(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;*
> *(iii) are neutral, ie free from bias;*
> *(iv) are prudent; and*
> *(v) are complete in all material respects.*

Accounting policies should be subject to the appropriate disclosure in financial statements. This is confirmed by NZ IAS 1, paragraph 108, which requires that:

> *An entity shall disclose in the summary of significant accounting policies:*
> *(a) the measurement basis (or bases) used in preparing the financial statements; and*
> *(b) the other accounting policies used that are relevant to an understanding of the financial statements.*

Often, an entity may make use of more than one measurement basis when preparing financial statements. For this reason, the disclosure of the different measurement basis or bases used in the preparation of the financial statements (for example, historical cost, current cost, net realisable value, fair value or recoverable amount) is necessary so that this can be taken into account when undertaking any analysis. Preparers of financial statements consider a number of issues when making a decision whether to disclose a particular accounting policy. Included in this is whether disclosure of the policy would assist users in understanding how transactions, other events and conditions are reflected in the reported financial performance and financial position. This is especially significant where there are a number of available alternative treatments, for example measurement bases for classes of assets or borrowing costs have been capitalised. In addition, the nature of the entity, its operations and the policies that the users of its financial statements would expect to be disclosed for that type of entity, should also be considered. For example, if the entity had significant foreign operations or transactions in foreign currencies, users could reasonably expect the disclosure of accounting policies that detailed how foreign exchange gains and losses would be recognised.

NZ IAS 1, paragraph 112, cautions that the nature of an entity's operations may result in an accounting policy being significant and therefore require disclosure, even though amounts for current and prior periods are immaterial. Any accounting policy selected in accordance with NZ IAS 8, but not specifically required by New Zealand equivalents to IFRS, should also be disclosed.

In the process of preparing financial statements, management is often required to make a number of judgements in applying the entity's accounting policies, since these may significantly affect amounts recognised in financial statements. Any judgements used in the preparation of the financial statements must therefore be disclosed.

7.6.3 Disclosure of management judgment

The issue of NZ IAS 1 by the FRSB introduced a number of new disclosure requirements. In addition to the disclosure of accounting policies, management is now required to disclose the judgements made by them when applying accounting policies. The requirements are clarified by NZ IAS 1, paragraph 113, as follows:

> *An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 116), management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.*

Some of the judgments made by management that can significantly affect the amounts recognised in the financial statements include:

- whether financial assets are held-to-maturity investments
- when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities
- whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue
- whether the substance of the relationship between the entity and a special purpose entity indicates that the special purpose entity is controlled by the entity.

7.6.4 Use of inappropriate accounting policies

It is important that financial statement preparers recognise that inappropriate accounting policies used in the preparation of financial statements cannot be rectified, or their impact minimised by disclosing the accounting policies used, providing appropriate supporting notes or additional explanatory material. However it is possible, albeit unlikely, that in certain rare instances management may conclude that compliance with an IFRS may be so misleading that it would be inconsistent with the objectives of financial statements set out in the NZ Framework. In these situations NZ IAS 1, paragraph 21, requires the entity reduce any perceived misleading aspects of compliance by disclosing the following information:

> *(a) the title of the Standard or Interpretation in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the NZ Framework; and*
>
> *(b) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.*

7.7 Other disclosures

7.7.1 Key sources of estimation uncertainty

In addition to disclosing judgments made by management, entities are required to provide certain additional information in the financial statement notes. This requirement is detailed in NZ IAS 1, paragraph 116, as follows

> *An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:*
>
> *(a) their nature; and*
>
> *(b) their carrying amount as at the balance sheet date.*

Determining the carrying amounts of some assets and liabilities at balance sheet date requires management to estimate the effects of uncertain future events on those assets and liabilities. These estimations may include assumptions about the discount rates used, trends in salaries and wages and their impact on long-term employee benefit liabilities, and changes in prices affecting other costs. Paragraph 116 states that disclosures need not be made in situations where the carrying amounts of assets and liabilities with a significant risk are likely to change materially within the next financial year if, at the balance sheet date, they were measured at fair value based on recently observed market prices. These disclosures should be made in such a way that users are able to understand managements' judgments and other key sources of estimation uncertainty. Examples of the disclosures that could be made here include:

(a) the nature of the assumption or other estimation uncertainty

(b) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity

(c) the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year, in respect of the carrying amounts of the assets and liabilities affected

(d) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved (NZ IAS 1, paragraph 120).

7.7.2 Dividends and other disclosures

There are a number of additional disclosures relating to dividends, the entities legal form, and domicile required by NZ IAS 1, paragraphs 125 and 126. Paragraph 125 requires entities to disclose the following information about dividends in the notes to the financial statements, namely:

- the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to equity holders during the period, and the related amount per share
- the amount of any cumulative preference dividends not recognised.

Information about the entity's domicile, legal form, country of incorporation, and address of its registered office (or principal place of business, if different from the registered office) must be disclosed in the notes if it is not included elsewhere in the financial report. A description of the nature of the entity's operations, its principal activities; and the name of the parent and the ultimate parent of the group should also be disclosed (NZ IAS 1, paragraph 126).

Exhibit 1 Statement of accounting policies

Starlam Limited
Statement of accounting policies for the year ended 31 December 2004

Reporting entity
Starlam Limited is a company registered under the *Companies Act 1993* and listed on the New Zealand Exchange. Starlam Limited is an issuer for the purposes of the *Financial Reporting Act 1993*. The financial statements of Starlam Limited have been prepared in accordance with the New Zealand *Companies Act 1993* and the *Financial Reporting Act 1993* (NZ IAS 1, 13.2).

Basis of preparation
The financial statements have been prepared in accordance with generally accepted accounting practice in New Zealand (NZ IAS 1, 13.1) and with International Financial Reporting Standards (NZ IAS 1, 14). The financial report has been prepared on the historical-cost basis, modified to include the revaluation of land and buildings and available-for-sale financial assets (NZ IAS 1, 103(a) and 108(a)). The presentation currency is New Zealand dollars (NZ IAS 1, 46(d)).

Specific accounting policies
The specific accounting policies that materially affect the measurement of financial performance and financial position are set out below. These policies have been applied consistently unless otherwise stated (NZ IAS 1, 103(a) and 108(b)).

(a*) Inventories*
Inventories are stated at the lower of cost, and net realisable value on a first-in, first-out method. Cost comprises direct material, direct labour costs and other costs incurred in bringing the inventories to their location and condition for sale. Cost is determined using the weighted average method. New realisable value represents the estimated selling price in the ordinary course of business, less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

(b) Property, plant and equipment
Land and buildings, which comprise factories and retail outlets, are stated at fair value, less accumulated depreciation and accumulated impairment losses. Revaluations are made by external independent valuations on a sufficiently regular basis, but at least triennially, to ensure that the carrying amount does not differ materially from the fair values at balance sheet date.

Revaluation increases arising on the revaluation of the land and building is credited to the Asset Revaluation Reserve, except to the extent that it reverses a revaluation decrease for the same asset previously recognised as an expense, in which case the increase is credited to the statement of financial performance to the extent of the decrease previously charged.

Other items of property, plant and equipment is stated at historical cost less accumulated depreciation. The cost of purchased fixed assets is the fair value of the consideration given to acquire the assets and the value of other directly attributable costs that have been incurred in bringing the assets to the location and condition necessary for their intended service. Where settlement of all or part of the cash consideration given in the acquisition of an asset is deferred, the fair value of the purchase consideration is determined by discounting the amounts payable in the future to their present value as at the date of acquisition.

(c) Revenue
Revenue is measured at the fair value of the consideration received or receivable and represents amounts receivable for goods and services provided in the normal course of business, net of discounts and General Sales Tax.

(i) *Sale of goods*
Revenue for the sale of goods and services is recognised when control over the goods has passed to the buyer.

(ii) *Interest income*
Interest income is recognised on a time-proportion basis using the effective interest method.

(e) Financial instruments
Financial assets and financial liabilities are recognised in the statement of financial position when the company become a party of the contractual provisions of the instrument.

(ii) Trade receivables
Trade receivables are initially recognised at fair value reduced by an allowance for estimated irrecoverable amounts. This allowance is established when there is objective evidence that the company will not be able to collect all amounts due to it under the original terms of the receivables.

In Exhibit 1, Starlam Limited is a company. As such, the statutory bases (NZ IAS 1, paragraph 13.2) on which it reports are the *Companies Act 1993* and the *Financial Reporting Act 1993*. However, had Starlam Limited been an entity other than a company, it would report under the legislation applicable to that type of entity. For example, a health board would report under the *New Zealand Public Health and Disability Act 2000* and the *Public Finance Act 1989*, a municipality would report in terms of the *Local Government Act 1974* and the *Public Finance Act 1989*, while universities would also report under the *Public Finance Act 1989*.

8 Statement of financial performance

The statement of financial performance provides information on the performance of the entity during a reporting period. This is achieved by disclosing the profit (loss) for a period, as well as the individual components taken into account in determining the profit (loss) arising from the activities and events necessary to assess both past and future financial performance. All revenues and expenses should be included in the statement of financial performance unless an accounting standard requires particular revenue of expense items to be included in the statement of changes in equity.

8.1 Relationship between an income statement prepared for internal reporting purposes and a statement of financial performance prepared for external reporting purposes

8.1.1 Income statement prepared for internal reporting purposes

Depending on how management structures the income statement for internal reporting purposes, it may at first glance, appear to bear little resemblance to a statement of financial performance prepared for external reporting purposes. For example, an income statement prepared for internal reporting purposes may list every major group of revenue and expense items and perhaps a profit (or loss) before and after taxation. However, the exact form the income statement takes depends on the requirements of the individual entity.

Income statements prepared for internal management purposes are used to monitor performance and the relationship between actual and budgeted revenues and expenses. An example of an income statement prepared for internal reporting purposes is shown in Exhibit 2.

Exhibit 2 An income statement prepared for internal reporting purposes

Xanadu Limited Income statement for the year ended 31 December 2006			
	Actual $	*Budget* $	*Variance* $
Sales	934 095	890 000	+44 095
Cost of sales	504 949	490 000	–14 949
Gross profit	429 146	400 000	+29 146
Other revenue items			
Dividends received	3 800	3000	+800
Interest received	993	500	+493
	4 793	3 500	+1 293
Total income	433 939	403 500	+30 439
Administration expenses			
Accounting fees	10 000	11 000	+1 000
Auditors' remuneration	5 500	4 000	–1 500
Bad debts	2 904	–	–2 904
Bank charges	1889	2000	+111
Cleaning	2 093	2 000	–93
Depreciation	3 934	3 500	–434
Donations	600	–	–600
Insurance	1 390	1 400	+10
Rental—administration building	6 890	7 000	+110
Repairs and maintenance	955	1 000	+45
Salaries and related expenses	93 087	95 000	+1 913
Teas	129 687	127 450	–2 237
Selling and distribution expenses			
Advertising expenses	55 345	50 000	–15 345
Motor vehicle expenses	19 451	21 200	+1 749
Rent—sales office	9 050	8 400	–650
Sales commission	115 909	95 000	+1 913
Staff sales salaries	55 443	60 000	+4 557
	255 198	224 600	–30 598
Financial expenses			
Bank overdraft interest	2 009	2 500	+491
Interest paid	4 445	4 500	+55
	6 454	7 000	+546
Total expenses	391 339	359 050	–32 289
Profit for the year	42 600	44 450	–1 850
Taxation	12 780	13 335	+555
Profit after taxation	29 820	31 115	–1 295

Clearly presenting a mass of information of this nature is unsuitable for external reporting purposes. For example, while it might be interesting for users to be aware of how much was spent on items as mundane as 'teas and cleaning', this detail does not necessarily provide them with information useful in making economic decisions.

8.1.2 Statement of financial performance prepared for external reporting purposes

When preparing a statement of financial performance for external reporting purposes, all items of income and expense recognised in a period are included in the calculation of the profit or loss for the period. For external reporting purposes, NZ IAS 1, paragraph 81, requires the following line items be disclosed on the face of the statement of financial performance:

(a) revenue;
(b) finance costs;
(c) share of the profit or loss of associates and joint ventures accounted for using the equity method;
(d) tax expense;
(e) a single amount comprising the total of
  (i) the post-tax profit or loss of discontinued operations; and
  (ii) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and
(f) profit or loss for the period

The preparation of a statement of financial performance that complies with the requirements of NZ IAS 1 differs significantly from the requirements contained in its predecessors, namely FRS-2 'Presentation of Financial Reports' and FRS-9 'Information to be Disclosed in Financial Statements'. The most significant change is the NZ IAS 1 requirement that the statement of financial performance present an analysis of expenditure, either on the face of the statement of financial performance or in the accompanying notes. This analysis must classify expenses either by their nature or their function (NZ IAS 1, paragraph 88).

8.2 Classification of expenses by nature

The classification of expenses by nature is the most simple of the two methods to apply. Under this method, expenses are simply aggregated in the statement of financial performance according to their nature. This means that expenses such as depreciation, purchases of materials, transport costs, employee benefits and advertising costs, are combined together and not reallocated among various functions of the entity such as administration expenses, cost of sales, distributions expenses, or marketing expenses. A simple example of a classification using the nature of expense method based on the requirements of NZ IAS 1, paragraph 91, is shown in Exhibit 3.

Exhibit 3 Statement of financial performance illustrating the classification of expenses by nature

Illustration Limited
Statement of financial performance
For the year ending 31 March 2006

	Notes	*2006* *$*	*2005* *$*
Revenue		**XXX**	**XXX**
Other income	1	XXX	XXX
Changes in inventories of finished goods and work in progress		(XXX)	XXX
Work performed by the entity and capitalised	2	XXX	XXX
Raw material and consumables used	3	(XXX)	(XXX)
Employee benefits expense		(XXX)	(XXX)
Depreciation and amortisation expense	4	(XXX)	(XXX)
Impairment expenses		(XXX)	(XXX)
Other expenses		(XXX)	(XXX)
Operating profit		XXX	XXX
Finance costs		**(XXX)**	**(XXX)**
Income from associates		**XXX**	**XXX**
Profit before tax		XXX	XXX
Income tax expense		**(XXX)**	**(XXX)**
Profit for the year		**XXX**	**XXX**
Attributable to:			
Equity holders of the parent		XXX	XXX
Minority interest		XXX	XXX
		XXX	XXX

8.3 Classification of expenses by function

Preparing a statement of financial performance according to the function of expenses requires the entity to allocate the costs according to their function as part of cost of sales, such as the costs of administration or distribution expenses. A problem associated with this method is that the allocation of the expenses may be arbitrary and involve considerable professional judgement.

Classifying expenses by function requires them to be allocated according to their function, for example, as part of cost of sales, distribution or administration expenses. NZ IAS 1, paragraph 92, suggests that this method of disclosing expenses can provide more relevant information to users than the classification of expenses by nature. A simple example of a classification using the function of expense method based on the requirements of NZ IAS 1, paragraph 92, is shown in Exhibit 4.

Exhibit 4 Statement of financial performance illustrating the classification of expenses by function

Illustration Limited
Statement of financial performance
For the year ending 31 March 2006

	Notes	*2006* *$*	*2005* *$*
Revenue	**1**	**XXX**	**XXX**
Cost of sales		XXX	XXX
Gross profit	2	XXX	XXX
Other income	3	XXX	XXX
Distribution costs		XXX	XXX
Administrative expenses	4	XXX	XXX
Other expenses		XXX	XXX
Operating profit		XXX	XXX
Finance costs		**XXX**	**XXX**
Income from associates		**XXX**	**XXX**
Profit before tax		XXX	XXX
Income tax expense		**XXX**	**XXX**
Profit for the year		**XXX**	**XXX**
Attributable to:			
Equity holders of the parent		XXX	XXX
Minority interest		XXX	XXX
		XXX	XXX

However, when the function of expenses method is used to prepare a statement of financial performance, NZ IAS 1, paragraph 93, requires the nature of expenses, such as depreciation and amortisation expense and employee benefits expense, be disclosed. The reason for this additional disclosure, which takes place in the accompanying notes, is that information on the nature of expenses is useful in predicting future cash flows. An example of the required disclosure is provided in Exhibit 5.

Exhibit 5 Supporting note to be provided when expenses are classified by function

	2006 $	2005 $
Note 6 Classification of expenses by nature		
Advertising	XXX	XXX
Changes in inventories of finished goods and work in progress	XXX	XXX
Raw material and consumables used	XXX	XXX
Depreciation of property, plant and equipment	XXX	XXX
Employment benefit expenses[1]	XXX	XXX
Impairment expenses	XXX	XXX
Other expenses	XXX	XXX
Rental expenses	XXX	XXX
Transport expenses	XXX	XXX

[1] A note supporting these expenses would provide additional information required by NZ IAS 19

Irrespective of whether the expenses are classified by nature or function, both the methods disaggregate the profit or loss for the period into the amounts attributable to the parent and minority shareholders. It should also be remembered that, irrespective of the format selected to present the statement of financial performance, the minimum information required by NZ IAS 1 must still be disclosed.

NZ IAS 1 provides no guidance on what smaller expense items should be combined into the 'other expenses' category. It is however suggested that in total this should not exceed some arbitrary figure, for example 10 per cent of total expenses. This figure should then be applied consistently from year to year.

8.4 The nature and function method of classifying expenses evaluated

Each method of presentation has merit for different types of entities. When deciding whether to use either the nature or function of expense method to prepare the statement of financial performance, management needs to select the method that is most relevant and reliable, and most fairly presents the elements of the entity's performance. In order to do so, a number of factors are considered. These include the historical and industry factors, as well as the nature of the entity. Irrespective of whether the nature or function of expense method is used, both methods identify those costs that vary, directly or indirectly, with the level of sales or production of the entity (NZ IAS 1, paragraph 94).

Irrespective of whether the statement of financial performance is prepared using the nature or function method, the same profit or loss for the period will result. It could be argued that the classification of expenses by nature suits smaller businesses because of its simplicity.

The function method may provide more relevant information to users. The reason for this is that users will be able to calculate the gross profit percentage, something that is perhaps more difficult using the nature of expenses classification method. As indicated earlier, when the statement of financial performance is prepared according to the function of expenses method, information relating to the nature of expenses must be disclosed because this information is necessary to enable users to predict future cash flows.

8.5 Finance costs

Although finance costs are not defined in NZ IAS 1, they are those costs that arise from an entity's financing of its operations. Although borrowed funds, in the form of loans, bank overdrafts and similar borrowings are the most common source of finance costs, they are not the only source. When reviewing financing costs, it is necessary to understand the term borrowing costs. NZ IAS 23, paragraph 4, defines borrowing costs as 'interest and other costs incurred by an entity in connection with the borrowing of funds' They include, according to NZ IAS 23, paragraph 5: interest on bank overdrafts; interest on short-term and long-term borrowings; amortisation of discounts and premiums on borrowings (for example debentures); amortisation of costs incurred in connection with the arrangement of borrowings; finance charges in respect of finance leases; and foreign exchange differences on foreign currency borrowings. However, finance costs are not limited to these items. A reading of NZ IAS 39 would suggest that finance costs also arise from the existence of convertible instruments. This would include interest and dividends paid, and losses relating to instruments classified as financial liabilities. A supporting note for finance costs is provided in Exhibit 6.

Exhibit 6 Recommended disclosure of finance costs

	2006	*2005*
	$	*$*
Note 6 Finance costs		
Bank overdraft interest	XXX	XXX
Capitalised leased assets	XXX	XXX
Interest on other borrowings	XXX	XXX
Dividends on redeemable preference shares	XXX	XXX
	XXX	XXX

8.6 Taxation

Income for taxation purposes is known as taxable income. It is determined in accordance with New Zealand income tax legislation, rather than accounting rules. Differences between the accounting and taxation revenue and expense recognition principles means that accounting income, (derived using accounting rules), and taxable income, (using the rules incorporated in income tax legislation), typically differ. Simple examples of the different revenue recognition principles would be dividends received from overseas companies being exempt from taxation, while certain expense items, including but not limited to, donations, certain legal expenses and fines, are not permitted as a deduction for taxation purposes.

The result is that the tax expense recorded in the statement of financial performance may differ from the taxation assessed by the Inland Revenue Department (IRD). The tax assessed by the IRD, and reflected in the current liability of income tax payable (which appears in an entity's statement of financial position), is based on the taxable profit derived by the entity. This is determined by applying the rules stipulated in taxation law, rather than the rules incorporated within accounting standards.

The tax expense, shown as a line item in the statement of financial performance is based on the accrual concept. It is calculated after applying all relevant accounting standards. What this means is that a company that generates a large profit before tax could, in certain circumstances, actually derive a loss for taxation purposes (and vice versa). This means that it is possible for an entity that discloses a large profit before tax in its statements of financial performance, may pay little or no tax.

To ensure that the tax charge shown in the statement of concepts is based on the accrual concept, the current tax (shown in Exhibit 7 and determined in accordance with taxation rules) must be adjusted upwards or downwards. This adjustment is referred to as a deferred taxation adjustment and leads to a deferred tax asset or liability. This is considered in more detail in section 10.3.4 below and in further detail in Chapter 17 of *New Zealand Financial Accounting 2e*.

Exhibit 7 Example of taxation supporting note

	2006 *$*	*2005* *$*
Note 6 Taxation		
Current tax	XXX	XXX
Deferred tax	XXX	XXX
	XXX	XXX
The tax on the profit before tax differs from the amount that would have arisen applying the tax rate to profits as follows:		
Profit before tax	XXX	XXX
Tax on profit at statutory rate – 30 per cent	XXX	XXX
Income not subject to tax	(XXX)	(XXX)
Expenses not deductible for tax purposes	XXX	XXX
Tax charge for the year	XXX	XXX

As indicated above, the differences between the accounting and taxation revenue and expense recognition principles may result in different tax figures being presented in financial statements causing confusion for certain financial statements users. To overcome this, paragraph 81 of NZ IAS 12 'Income Tax', requires entities explain the relationship between the tax expense and the accounting profit. This can take the form of a numerical reconciliation of the tax expense and the product of the accounting profit multiplied by the tax rate, or by reconciling the average tax rate and the applicable tax rate.

8.7 Xanadu Limited—a practical example

Using the format, classifying expenses by function shown in Exhibit 4, the statement of financial performance for Xanadu Limited for the reporting period ending 31 March 2006 would appear as set out in Exhibit 8. Caution should be exercised in this example because as can be seen, the income statement provided for Xanadu Limited provides insufficient information for complete notes to be provided.

Exhibit 8 Statement of financial performance that complies with NZ IAS 1 requirements

Xanadu Limited
Statement of financial performance
For the year ending 31 March 2006

	Notes	*2006*	*2005*
		$	*$*
Revenue		934 095	XXX
Cost of sales		504 949	XXX
Gross profit		429 146	XXX
Other income	2	4 793	XXX
Administrative expenses		129 687	XXX
Distribution and selling expenses		255 198	XXX
Operating profit	3	49 054	XXX
Finance costs	4	6 454	XXX
Profit before tax		42 600	XXX
Income tax expense		12 780	XXX
Profit for the year		29 820	XXX
Note 2 Other income			
Dividends received		3 800	XXX
Interest received		993	XXX
		4 793	XXX
Note 3 Operating profit			
Operating profit has been arrived at after taking into account the following items:			
Auditors' remuneration—audit fees		5 500	XXX
Donations		600	XXX
Note 4 Finance costs			
Interest paid		6 454	XXX
Note 5 Classification of expenses by nature			
Advertising		55 346	XXX
Bad debts		2 904	
Changes in inventories of finished goods and work in progress[1]		XXX	XXX
Raw materials and consumables used[1]		XXX	
Depreciation expenses		3 934	XXX
Employment benefit expenses		264 439	XXX
Rental expenses		15 940	XXX

[1] Insufficient information available to provide these figures

8.8 Statement of financial performance components

As has been indicated earlier, the objective of financial reporting is to provide information about the financial position, financial performance and changes in financial position of an entity that is useful for a wide range of users in making economic decisions. From a user's

perspective, this can be achieved only if they are aware of the composition of individual items in the various statements.

From a statement of financial performance perspective, this is acknowledged by NZ IAS 1, paragraph 83. This paragraph requires entities to disclose additional line items, headings and subtotals on the face of the statement of financial performance where it is relevant to an understanding of the entity's financial performance. The reason for these additional disclosures is that an entity's various activities, transactions and other events differ in frequency, potential for gain or loss, and predictability. Disclosing the material components of financial performance therefore assists users in understanding an entity's financial performance and in projecting future results.

8.8.1 Expanding on the information disclosed in the statement of financial performance

As indicated earlier, NZ IAS 1 details the minimum line items that should appear in a statement of financial performance. An amendment of importance to New Zealand preparers of financial statements is the prohibition on the separate disclosure of extraordinary items. This is confirmed in NZ IAS 1, paragraph 85, which provides that 'An entity shall not present any items of income and expense as extraordinary items, either on the face of the income statement or in the notes'. In spite of this requirement, material income and expense items must be separately disclosed.

The separate disclosure of material revenue or expense items is justified on the grounds that the identification of these items is necessary to meet the objectives of financial reporting. Additional information is provided that enables users to assess the financial performance of the entity and make decisions about providing resources to or doing business with the entity. When examining individual income and expense items, factors to consider in determining whether they require separate disclosure include, materiality, and the nature and function of the components of income and expenses.

8.8.2 Revenue

One of the more important NZ IAS 1 disclosure requirements is the paragraph 81(a) requirement to disclose revenue. Bearing in mind that revenue is a subset of income, NZ IAS 18 'Revenue', paragraph 7, defines it as:

> *the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.*

An accurate determination of revenue is necessary to enable the profit or loss for the year to be calculated. Revenue includes sales, lease, rental, and investment income. Generally,

revenue is determined by taking sales, deducting returns and allowances, less any duties, taxes or other amounts collected on behalf of third parties. For public sector entities, revenue includes items such as taxes, fines, rates, donations, grants and resource rentals, while revenue for not-for-profit entities, includes donations and subscriptions.

Merely disclosing revenue would generally provide insufficient detail for the information needs of users. This is recognised by the specific requirements of both NZ IAS 1 and NZ IAS 18. While NZ IAS 1, paragraph 86, requires the separate disclosure of items of income that are material, NZ IAS 18, paragraph 35(b), requires the separate disclosure of:

> *the amount of each significant category of revenue recognised during the period including revenue arising from:*
> *(i) the sale of goods;*
> *(ii) the rendering of services;*
> *(iii) interest;*
> *(iv) royalties; and*
> *(v) dividends*

In addition, NZ IAS 18, paragraph 35(c), requires the amount of revenue arising from exchanges of goods or services included in each significant category of revenue, to be disclosed.

A literal translation of these requirements suggest that companies such as Telecom New Zealand Limited should separately disclose line rental revenue and revenue from overseas, local, toll, and mobile calls. For Air New Zealand Limited the separate disclosure of passenger and freight revenue could be useful. This could be further broken down into local and international passenger and freight revenue. A note detailing the disclosure of revenue items that complies with the requirements of NZ IAS 1 and NZ IAS 18 is provided in Exhibit 9.

Exhibit 9 Disclosure of revenue and other income

	2006	*2005*
	$	*$*
Note 2 Revenue		
Sale of goods	XXX	XXX
Rental income	XXX	XXX
Construction contract revenue	XXX	XXX
	XXX	XXX
Note 3 Other revenue		
Dividends received	XXX	XXX
Interest received	XXX	XXX
	XXX	XXX

8.8.3 Expenses

What is interesting and has been considered earlier, is that in the past the majority of New Zealand entities did not disclose material expense items, including cost of goods sold, or wages, or even categories of expenses such as administration, marketing or financial. There is no question that, for a significant number of entities, these items formed a significant component of profit before tax. This being so, it is easy to sympathise with the position adopted by Lont (1997, p. 166) when he argued that the nondisclosure of significant expense items such as cost of sales effectively amounted to non-compliance with GAAP. In his subsequent study, Lont (2002, p.27) is more critical arguing:

> *Widespread non-compliance suggests New Zealand's approach lacks the necessary rigor for auditors to qualify the financial reports. Due to weaknesses in the Financial Reporting Act, without an audit qualification, it is unlikely regulatory bodies would seek to contest the lack of disclosure.*

While the inadequate disclosure of expenses that previously occurred in New Zealand has been acknowledged, what is less certain is whether this situation is likely to continue under the new financial reporting regime. As indicated earlier, NZ IAS 1 requires the disclosure of expenses either by nature or by function. Under the nature classification, expenses are aggregated according to their nature. Items such as depreciation, purchases of materials, transport costs, employee benefits and advertising costs, are combined together and not reallocated among various functions of the entity. Under the function classification, expenses are aggregated by their function as part of cost of sales or costs of distribution or administration activities. Although NZ IAS 1 considers the function classification of expenses to provide more relevant information, it nevertheless requires information on the nature of expenses to be provided in the accompanying financial statement notes.

Consistent with the objectives of financial statements, the nature and amount of material expense items must be separately disclosed. Further guidance on the nature of items that may require separate disclosure, should circumstance dictate, is provided in NZ IAS 1, paragraph 87, and includes:

> *(a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;*
> *(b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;*
> *(c) disposals of items of property, plant and equipment;*
> *(d) disposals of investments;*
> *(e) discontinued operations;*
> *(f) litigation settlements; and*
> *(g) other reversals of provisions.*

When developing NZ IAS 1, the FRSB included a number of additional disclosure requirements for all entities. These disclosures which can be made either on the face of the income statement or in the notes, related to fees paid to auditors and donations made. They were included in NZ IAS 1 to ensure consistent disclosures by all entities, including companies, as well as retain consistency with certain of the section 211 of the *Companies Act 1993* disclosure requirements. The disclosure requirement for fees paid to auditors, shown in Exhibit 10, is particularly detailed, as can be seen by the NZ IAS 1, paragraph 94.1, requirement for entities to disclose separately fees to:

> *(a) each (if more than one) auditor of the parent entity for:*
>
> > *(i) audit fees being fees for the audit of the financial statements;*
> >
> > *(ii) audit related fees being fees for assurance and related services that are reasonably related to the performance of the audit or review of the financial statements and are not reported under paragraph (a)(i). An entity shall describe the nature of the services comprising the fees disclosed under this category;*
> >
> > *(iii) tax fees being fees for tax compliance, tax advice, and tax planning services. An entity shall describe the nature of the services comprising the fees disclosed under this category; and*
> >
> > *(iv) all other fees being fees for services other than those reported in paragraphs (a)(i) through (a)(iii). An entity shall describe the nature of the services comprising the fees disclosed under this category; and*
>
> *(b) any other auditor(s) of entities in the group (not including the parent entity) for audit fees being fees for the audit or a review of the financial statements.*

While the disclosure of other expense items or categories of expenses is not mandated, an overriding consideration for financial statements is that they should present a true and fair view of the financial performance, financial position and cash flows of the entity—which can only be achieved if all material items are disclosed.

It should also be remembered that those expense items requiring separate disclosure are not found only in NZ IAS 1. Other accounting standards provide details of those additional disclosures that must be made in the notes supporting the statement of financial performance. It is possible for these to be included in the nature of expenses disclosures.

Exhibit 10 Disclosure of expenses

	2006 *$*	*2005* *$*
Note 3 Operating profit		
Operating profit (loss) has been arrived at after taking into account (or crediting) the following items:		
Amortisation of internally generated intangible assets (included in other operating expenses)	XXX	XXX
Auditors' remuneration		
Audit services		
Fee for statutory audit	XXX	XXX
Tax services		
Taxation compliance services	XXX	XXX
Taxation advisory services	XXX	XXX
	XXX	XXX
Other services		
Financial information technology	XXX	XXX
Internal audit	XXX	XXX
Recruitment	XXX	XXX
	XXX	XXX
Total auditors' remuneration	XXX	XXX
Cost of inventories recognised as expenses	XXX	XXX
Depreciation of property, plant and equipment	XXX	XXX
Donations	XXX	XXX

8.9 Discontinued operations

Entities often comprise a number of operations that can clearly be distinguished for operational and financial reporting purposes. For example, a retailer may operate a number of outlets throughout the North Island, or a widely diversified entity may operate through a number of divisions, for example, an agriculture, manufacturing and transport division.

Where an entity disposes of, or ceases to operate a branch, manufacturing division where no other division produces the same product, or other business segment, this can be classified as a discontinued operation. Care should be taken when classifying a discontinued operation. For example, the discontinuation of a particular product line by a retailer would not be considered a discontinued operation. However, should the retailer cease its manufacturing activities, this would be classified as a discontinued activity. By the same token, if an entity closes down a retail outlet in Hamilton but continues to operate retail outlets in other towns, this would not constitute a discontinued operation. It could be more accurately classified as a restructuring activity.

Where an entity discontinues an operation, then it is required to comply with the requirements of NZ IFRS 5, 'Non-current Assets Held for Sale and Discontinued Operations'. The rationale for this is contained in NZ IFRS 5, paragraph 30, which requires entities to present and disclose such information that will enable users of the financial statements to evaluate the financial effects of discontinued operations. For the purposes of applying NZ IFRS 5, entities must identify individual components of a business. Here a component of an entity is described as a cash-generating unit or a group of cash-generating units while being held for use.

A discontinued operation is a component of an entity that has either been disposed of, or is classified as held for sale, and it:

- ♦ represents a separate major line of business or geographical area of operations
- ♦ is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or

is a subsidiary acquired exclusively with a view to resale. Where this occurs the NZ IFRS 5, paragraph 33 requires the entity to disclose:

(a) a single amount on the face of the income statement comprising the total of:
  - *(i) the post-tax profit or loss of discontinued operations and*
  - *(ii) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.*

(b) an analysis of the single amount in (a) into:
  - *(i) the revenue, expenses and pre-tax profit or loss of discontinued operations;*
  - *(ii) the related income tax expense as required by paragraph 81(h) of NZ IAS 12;*
  - *(iii) the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and*
  - *(iv) the related income tax expense as required by paragraph 81(h) of NZ IAS 12.*

The detailed disclosure, shown in Exhibit 11, can take place either on the face of the statement of financial performance or in the accompanying notes. The reason for separately disclosing continuing operations from discontinued operations is logical. In the current period, results from discontinued operations form a component of the profit before taxation for the period. Knowledge of discontinued operations is therefore necessary to assess the performance of the entity for the period. If the results from discontinued activities were not provided, users' assessment of the entity's future financial performance could be impaired.

Exhibit 11 Statement of financial performance disclosing operating revenue and operating surplus (deficit) from continuing and discontinued activities

Illustration Limited
Statement of financial performance
For the year ending 31 March 2006

	Notes	*2006* *$*	*2005* *$*
Revenue		XXX	XXX
Cost of sales		XXX	XXX
Gross profit		XXX	XXX
Other income		XXX	XXX
Distribution costs		XXX	XXX
Administrative expenses		XXX	XXX
Other expenses		XXX	XXX
Operating profit		XXX	XXX
Finance costs		XXX	XXX
Income from associates		XXX	XXX
Profit before tax		XXX	XXX
Taxation		XXX	XXX
Profit for the year from continuing operations		XXX	XXX
Discontinued operations			
Profit for the year from discontinued operations	5	XXX	XXX
Profit for the year		XXX	XXX
Note 5 Profit for the year from discontinued operations			
Revenue		XXX	XXX
Expenses		XXX	XXX
Profit before tax from discontinued operations		XXX	XXX
Taxation		XXX	XXX
Profit for the year from discontinued operations		XXX	XXX

The accompanying statement of financial position disclosures are detailed in section 10.5

8.10 Directors' remuneration

At this stage it is appropriate to discuss the concepts of 'director' and 'directors' remuneration'. There are two main categories of directors, namely executive and non-executive. Executive directors are those who are active in the daily management of the company. An example would be a financial director who is also responsible for the day-to-day accounting and other financial activities and who also serves on the board. A non executive director only serves on the board. They are not active in the daily management of the entity. A typical example of a non executive director would be the chairman of the board of directors.

The principal underlying directors' remuneration can be found in the *New Zealand Corporate Governance Handbook*. Here it requires the remuneration of directors and executives to be 'transparent, fair, and reasonable' (2004, p. 18). In order to ensure the

transparency envisaged by the *New Zealand Corporate Governance Handbook* occurs, appropriate and complete disclosures should be made in the entity's financial statements.

In recent years, the disclosure of directors' remuneration by New Zealand entities has generally been less than complete. Section 211(1)(f) of the *Companies Act 1993* requires the total of the remuneration and value of other benefits received by each director or former director of a company to be disclosed. In addition, NZ IAS 24, paragraph 16, requires the disclosure of key management personnel compensation in total.

A director is defined in section 126(1)(a) of the *Companies Act 1993* as a person occupying the position of director of a company by whatever name called. Section 126(1)(b) expands the definition of 'director' to include the *de facto* controller of the company. This means that the term 'director' includes:

- any person in accordance with whose directions or instructions someone occupying the position of director might be required or is accustomed to act
- any person in accordance with whose instructions the board of the company might be required or is accustomed to act
- any person who exercises, is entitled to exercise, controls or is entitled to control the exercise of powers that would be exercised by the board were it not for the constitution of the company providing otherwise
- any person to whom a power or duty of the board has been directly delegated by the board, and who consents to that power, and exercises the power or duty with the consent of the board.

Under the *Companies Act 1993*, the term 'director' also includes any person acting as a director of an entity, irrespective of name, and whether or not their appointment is valid or they are duly authorised to act. The term 'director' also includes directors and alternate directors or entities, and in certain circumstances, trustees and liquidators in relation to the entities they are responsible for liquidating.

The term director is not defined in NZ IAS 24. However, the term 'key management personnel' is defined which, it is submitted, is broader than the term 'director'. The definition of 'key management personnel' in NZ IAS 24 is very broad. They are defined in paragraph 9, as 'those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity'. What this means, is that any person occupying the position of a member (by whatever name called) of the governing body of the entity reporting is considered

to be a key member of management. This would include all officially appointed directors, as well as others recognised under the entity's constitution or equivalent documentation as holding such a position. Examples of key management would include:

- ministers—for the government as a whole
- departmental chief executives—for government departments
- councillors and board members—for other public sector entities and non-profit entities
- any partner in a partnership (other than a special partnership),
- any general partner in a special partnership
- any person occupying a position comparable with that of director of a company in any other corporate or unincorporated body.

In most New Zealand companies, the term 'key management personnel' would mean directors.

8.10.1 Items included in directors' remuneration

Although the term directors' remuneration is not defined in NZ IAS 1 or the *Companies Act 1993*, the term compensation is defined in NZ IAS 24. Paragraph 9 describes compensation as including all employee benefits. In terms of this paragraph, employee benefits include all forms of consideration paid or payable by the entity on its behalf. The term compensation is very wide and can be monetary or non-monetary in nature. In the context of this book, compensation is a reward for services provided to the entity by employees, and in the context of this section, key members of management.

Monetary compensation includes: short term employee benefits such as salaries; wages; paid annual and sick leave and bonuses (annual and profit sharing), while non-monetary rewards include medical contributions, housing or motor vehicle allowances and free or subsidised goods or services. Also included in the definition of compensation are items such as: post-employment benefits including pensions; other retirement benefits; life or medical insurance; long service leave; long term profit sharing bonuses; deferred compensation; termination benefits; and equity compensation benefits.

Payments that would not be considered remuneration include: reimbursement of valid company expenses; dividends received; interest on funds advanced to the entity; and accrued sick leave or long-service leave. The last two items are not earned until the leave is taken at which time they form part of remuneration.

8.10.2 Disclosure of directors' remuneration

Until recently, the disclosure of directors' remuneration in New Zealand was often limited to total directors' fees. Directors' fees are the fees paid to the director for the services provided by them for the service of acting as a director of the entity. NZ IAS 24 details the disclosures that an entity should make in their financial statements. Paragraph 16, of NZ IAS 24 requires entities to disclose key management personnel compensation in total and for each of the following categories:

(a) short-term employee benefits
(b) post-employment benefits
(c) other long-term benefits
(d) termination benefits
(e) equity compensation benefits.

The problem in a complex or widely diversified organisation is that there may be a significant number of key management personnel. Each of them may have delegated authority and responsibility for planning, directing and controlling the various activities of different business divisions. This means that the usefulness of disclosing all their remuneration in aggregate is questionable, and as such, is unlikely to increase or provide the users of the financial statements with relevant information. As indicated earlier, the definition of key management personnel is so broad that entities are unlikely to be consistent in their interpretation of the type of employees that fall within the definition.

It could be argued that the broad nature of the definition of key management personnel, and the broad categories of disclosures required by NZ IAS 24, paragraph 24, will do little to improve transparency, enhance comparability, or assist users of the financial statements. Given this, and the fact that the NZ IAS 24 only requires entities to disclose an aggregate remuneration figure, it could be argued that users could be more confused than if no information was disclosed. Finally, comparing information between entities at an aggregated level may mislead users due to the degree of subjectivity involved in determining key management personnel.

This problem is alleviated to a certain extent in New Zealand in that the NZ IAS 24 disclosure requirements must be combined with the provisions of the *Companies Act 1993*. Section 211(f) requires entities to '[s]tate, in respect of each director or former director of the company, the total of the remuneration and value of other benefits received by that director or former director during the accounting period'. What this suggests is that to comply with both

the NZ IAS 24 and section 211(1)(f) requirements, the paragraph 16 disclosure requirements must be made for each key management personnel.

If this is the case, these disclosure requirements are a significant improvement on what had occurred previously. Although NZ IAS 24 does not require a detailed breakdown of the components of directors' remuneration (annual benefits, post-employment benefits, equity compensation benefits), or the disclosure of remuneration to specified executives (generally the five most highly paid), section 211(1)(f) of the *Companies Act 1993* should ensure that this information is disclosed. It is submitted that the detailed disclosure of information relating to key management compensation will enable users of financial statements to carefully consider the performance of key management including directors, in light of the performance of the entity.

8.10.3 Directors' remuneration and consolidated financial statements

As was indicated earlier, section 211(1)(f) of the *Companies Act 1993* requires the disclosure of the total of the remuneration and value of other benefits received by each director or former director. What is less clear, however, is the position where group financial statements are concerned. It is submitted that where group financial statements are prepared, the disclosure of this information should include the value of the remuneration and other benefits paid to the directors of all subsidiaries, even though directors of subsidiaries might not necessarily be directors of the parent company. Exhibit 12 outlines disclosure of directors' remuneration that complies with the requirements of NZ IAS 24 and section 211(1)(f) of the *Companies Act 1993,* and in the spirit of the *New Zealand Corporate Governance Handbook.*

Exhibit 12 Note disclosing directors' remuneration

	2006 *$*	*2005* *$*
Note 25 Directors' remuneration (s 211 *Companies Act 1993*) Directors of the company during the year and their remuneration and other benefits paid were as follows:		
A.S. Smith		
Salaries and other short-term employee benefits	XXX	XXX
Other long-term benefits	XXX	XXX
Equity compensation benefits	XXX	XXX
Total director's remuneration	XXX	XXX
J.L. Lance		
Salaries and other short-term employee benefits	XXX	XXX
Other long-term benefits	XXX	XXX
Equity compensation benefits	XXX	XXX
Total director's remuneration	XXX	XXX
P.T. Jones (resigned 30 November 2005)(s 211(1)(i))		
Salaries and other short-term employee benefits	XXX	XXX
Post-employment benefits	XXX	XXX
Equity compensation benefits	XXX	XXX
Termination benefits	XXX	XXX
Total director's remuneration	XXX	XXX
L.J. Brooke (appointed 1 December 2005) (s 211(1)(i))		
Salaries and other short-term employee benefits	XXX	-
Total director's remuneration	XXX	-
Total director's remuneration		
Salaries and other short-term employee benefits	XXX	XXX
Post-employment benefits	XXX	XXX
Other long-term benefits	XXX	XXX
Termination benefits	XXX	XXX
Equity compensation benefits	XXX	XXX
	XXX	XXX

8.11 Companies Act 1993 disclosure requirements

From a reading of section 211, it is clear that two forms of disclosure are required: narrative and numeric.

8.11.1 Narrative disclosures

The narrative portion of the annual report requires disclosure of a description of the state of the company's affairs. Care should be taken that this is not provided in a form that could be considered harmful to the company (or its subsidiaries). Information on changes in the nature of the business of the company, its subsidiaries or the classes of business in which the company has an interest, must be included. Descriptions of any changes made to accounting

policies are included in the narrative. Finally, the names of the directors of the company as at the end of the accounting period, as well as the names of the persons who ceased to hold office as directors of the company during the period, must be provided.

The information included in the narrative may include a financial review describing and explaining the main features of the entity's financial performance, financial position as well as the principal uncertainties facing it. As NZ IAS 1, paragraph 9, explains, such a report may include a review of:

(a) *the main factors and influences determining financial performance, including changes in the environment in which the entity operates, the entity's response to those changes and their effect, and the entity's policy for investment to maintain and enhance financial performance, including its dividend policy;*

(b) *the entity's sources of funding and its targeted ratio of liabilities to equity; and*

(c) *the entity's resources not recognised in the balance sheet in accordance with New Zealand equivalents to IFRSs.*

These disclosures are often included in a directors' or chief executives officers' report.

8.11.2 Numeric disclosures

Although the *Companies Act 1993* numeric disclosure requirements are limited to four items, it should be remembered that more extensive disclosure requirements are contained in the individual accounting standards. First, section 211 requires the total remuneration and the value of other benefits received by each director or former director must be disclosed. Second, include a listing of the number of employees or former employees of the company, (not directors of the company), who receive remuneration and other benefits in their capacity as employees exceeding $100 000 per annum. The number of employees or former employees in this group must be provided in brackets of $10 000 (detailed in Exhibit 13). Third, the total amount in donations made by the company and any subsidiary, must be disclosed. Finally, amounts payable to the auditor of the company as audit fees and for other services should be detailed. In addition, Section 211(1)(e) also requires the particulars of entries in the interests register to be stated. These disclosures are usually included in the notes accompanying the financial statements.

Exhibit 13 Disclosure of employees' remuneration over $100 000

	2006	*2005*
Note 26 Employees' remuneration Remuneration and other benefits of $100 000 per annum or more received by employees in their capacity as employees		
	Number of employees	Number of employees
$100,000–$109,999	3	2
$110,000–$119,999	1	2
$130,000–$139,999	2	1

The brevity of certain disclosure items in the *Companies Act 1993* disclosure items (also included in NZ IAS 1) must be questioned. For example, the requirement of paragraph NZ 94.2, of NZ IAS 1, and section 211(h) of the *Companies Act 1993* for the disclosure of donations made by any entity is meaningless and, in fact, could even be construed as misleading. For example, disclosing a donation of $100 000 without further explanation could imply a philanthropic gesture. However, the fact that such a donation might have been made to a political party in the hope that after the next election a controversial resource consent application would be fast-tracked, would throw a completely different light on the nature of the donation, and might influence users' investment decisions.

9 Statement of changes in equity

The statement of changes in equity contributes to attaining the objectives of general purpose financial reporting by combining information about the profit (or loss) for the period (from the statement of financial performance) with other aspects of an entity's performance (statement of changes in equity) in the item 'Total recognised income and expenses'. This is effectively a measure of comprehensive income. When examined in conjunction with the statement of financial position, it also provides information useful for assessing return on investment. The statement of changes in equity reconciles equity at the beginning of the period with equity at the end of the period. The statement of changes in equity between two balance dates reflects the increase or decrease in the net assets of an entity during the period. Other than transactions with owners in their capacity as owners, the change in equity during the period represents the total amount of income and expenses, including gains and losses, generated by the entity's activities for the period. This focus taken by a statement of changes in equity is consistent with an economists' concept of profit (an increase in wealth over a period) rather than a having an accounting focus which is transactions based.

Although NZ IAS 1 does not prescribe a particular format for the statement of changes in equity, the appendix provides two alternatives entities may use. Entities are free to use whatever format best suits their purpose provided the information required by NZ IAS 1 is disclosed. At a minimum, paragraph 96 requires the following information be disclosed on the face of the statement of changes in equity:

(a) profit or loss for the period;

(b) each item of income and expense for the period that, as required by other Standards or by Interpretations, is recognised directly in equity, and the total of these items;

(c) total income and expense for the period (calculated as the sum of (a) and (b)), showing separately the total amounts attributable to equity holders of the parent and to minority interest; and

(d) for each component of equity, the effects of changes in accounting policies and corrections of errors recognised in accordance with NZ IAS 8.

A number of additional items are required to be disclosed in the statement of changes in equity. These disclosures can take place either on the face of the statement or in the accompanying notes. The first is the amount of transactions with equity holders acting in their capacity as equity holders. This must separately disclose distributions to equity holders. Second, the balance of retained earnings at the beginning of the period must be reconciled with the balance of retained earnings at the balance sheet date. All changes during the period should be disclosed. Finally, the carrying amount of each class of contributed equity and each reserve at the beginning of the period must be reconciled to the carrying amount at the end of the year. Each change is to be disclosed separately.

As NZ IAS 1 requires all items of income and expenses recognised in a period to be included in the profit or loss, the only items that should be included in the statement of changes in equity are those required by an accounting standard or interpretation. These other standards deal with items that may meet the NZ Framework definitions of income or expense but are usually excluded from profit or loss. Examples include revaluation surpluses or deficits (see NZ IAS 16), particular gains and losses from translating the financial statements of a foreign operation (see NZ IAS 21) and gains or losses on re-measuring available-for-sale financial assets (see NZ IAS 39).

As indicated in paragraph 96(d) above, retrospective changes in accounting policies required under NZ IAS 8 and retrospective corrections of errors are made in the statement of changes in equity. This is considered further in Chapter 16 of the accompanying text, *New Zealand Financial Accounting 2e*.

NZ IAS 1 suggests that the statement of changes in equity disclosure requirement can be met in a number of ways. The first shown in Exhibit 14, illustrates the columnar format where opening and closing balances are reconciled. All the items required by NZ IAS 1, paragraph 96, can be identified.

Exhibit 14 Statement of changes in equity

Illustration Limited
Statement of changes in equity
For the year ending 31 March 2006

	Notes	Contributed equity	Other reserves[1]	Translation reserve	Retained earnings	Total
Balance at 31 March 2004		XXX	XXX	XXX	XXX	XXX
Changes in accounting policy		-	-	-	XXX	XXX
Restated balance		XXX	XXX	XXX	XXX	XXX
Changes in equity for 2005						
Gain on property revaluation			XXX	-	-	XXX
Exchange differences on translating foreign operations			-	XXX	-	XXX
Net income recognised directly in equity			XXX	-	XXX	XXX
Profit for the year			-	-	XXX	XXX
Total recognised income and expenses			XXX	XXX	XXX	XXX
Distributions	12		-		XXX	XXX
Balance at 31 March 2005		XXX	XXX	XXX	XXX	XXX
Changes in equity for 2006						
Loss on property revaluation			XXX	-	XXX	XXX
Exchange differences on translating foreign operations			-	XXX	-	XXX
Tax on items taken directly to or transferred from equity			XXX	XXX	-	XXX
Net income recognised directly in equity			XXX	XXX	XXX	XXX
Profit for the year			-	-	XXX	XXX
Total recognised income and expenses			XXX	XXX	XXX	XXX
Distributions[2]	12	XXX	-	-	XXX	XXX
Proceeds from share issue		XXX				XXX
Balance at 31 March 2006		XXX	XXX	XXX	XXX	XXX

1 Other reserves should be analysed into their separate components if material
2 May include share buybacks

The second, detailed in Exhibit 15, is shown as a statement of recognised revenues and expenses. Here the first three items listed in paragraph 96 are separately disclosed, with the remaining items shown in the accompanying notes.

Exhibit 15 Statement of recognised revenues and expenses

Illustration Limited
Statement of recognised income and expenses
For the year ending 31 March 2006

	Notes	*2006*	*2005*
Gain/(loss) on revaluation of properties		XXX	XXX
Available-for-sale investments:			
Valuation gains/(losses) taken to equity		XXX	XXX
Transferred to profit or loss on sale		XXX	XXX
Cash flow hedges:			
Gains/(losses) taken to equity		XXX	XXX
Transferred to profit or loss for the period		XXX	XXX
Transferred to the initial carrying amount of hedged items		XXX	XXX
Exchange differences on translation of foreign operations		XXX	XXX
Tax on items taken directly to or transferred from equity		XXX	XXX
Net income recognised directly in equity		XXX	XXX
Profit for the period		XXX	XXX
Total recognised income and expenses		XXX	XXX
Attributable to:			
Equity holders of the parent		XXX	XXX
Minority interest		XXX	XXX
		XXX	XXX

The approach used in Exhibit 15 details those changes in equity which represent income and expenses as a separate component of the financial statements. When this approach is used, a reconciliation of the separate components of equity, namely contributed equity, reserves and retained earnings, must be provided in the accompanying notes. An example of this is provided in Exhibit 16.

Exhibit 16 Reconciliation of equity components when Statement of recognised income and expenses is provided

	Revaluation reserve	Available-for-sale investments	Hedging reserve	Translation reserve	Retained earnings	Total
Balance 1 April 2004	XXX	XXX	XXX	XXX	XXX	XXX
Revaluation increase land and buildings	XXX	-	-	-	-	XXX
Cash flow hedge					-	
Fair value gain	-	-	XXX	-	-	XXX
Transferred to profit and loss	-	-	XXX	-	-	XXX
Exchange difference on translation	-	-	-	XXX	-	XXX
Net income recognised directly in equity	XXX	XXX	XXX	XXX	-	XXX
Profit for the year	-	-	-	-	XXX	XXX
Distributions	-	-	-	-	XXX	XXX
Balance at 31 March 2005	XXX	XXX	XXX	XXX	XXX	XXX
Revaluation decrease land and building	XXX	-	-	-	-	XXX
Transferred to retained earnings on disposal of land	XXX	-	-	-	XXX	-
Available-for-sale investment						
Valuation gains	-	XXX	-	-	-	XXX
Transferred to profit and loss	-	XXX	-	-	-	XXX
Cash flow hedge						
Fair value gain	-	-	XXX	-	-	XXX
Exchange difference on translation	-	-	-	XXX	-	XXX
Net income recognised directly in equity	XXX	XXX	XXX	XXX	-	XXX
Profit for the year	-	-	-	-	XXX	XXX
Distributions	-	-	-	-	XXX	XXX
Balance at 31 March 2006	XXX	XXX	XXX	XXX	XXX	XXX

Where an entity maintains separate components of equity and transfers between reserves occur, these are reflected in the statement of changes in equity, and may also be disclosed in the notes. An example of this would be when an item of property, plant and equipment that has been subject to an upward revaluation is disposed of and the balance on the revaluation reserve is transferred to retained earnings.

An example of a supporting note to the statement of changes in equity would include distributions to owners. This is illustrated in Exhibit 17.

Exhibit 17 Example of supporting note to statement of changes in equity

	2006 $	2005 $
Note 12 Distributions to owners		
Dividends and interest		
Ordinary shares	XXX	XXX
Preference shares	XXX	XXX
Convertible notes	XXX	XXX
	XXX	XXX
Share buy-back		
Acquisition of Y ordinary shares by the company	XXX	XXX
	XXX	XXX

10 Statement of financial position

The statement of financial position can be thought of as a snapshot of assets and liabilities at a certain point in time. Essentially, a statement of financial position provides information about the assets, liabilities and equity of an entity and the interrelatedness of these elements at a particular date. Although NZ IAS 1 fails to detail any objectives of the statement of financial position, these can however be established from a reading of the NZ Framework.

Essentially information about the financial position is useful in assisting users to understand how the entity (NZ Framework, paragraph 16):

- will modify the economic resources it controls to generate cash and cash equivalents
- will be distribute future profits and cash flows among those with an interest in the entity
- will raise further finance
- will meet its financial commitments as they fall due (liquidity and solvency).

It is important to remember that a statement of financial position does not purport to reflect the value of an entity. The statement of financial position, other statements, accompanying notes together with other supplementary information, provides information useful to users who wish to make their own estimate of the entity's value.

Neither the *Companies Act 1993* nor NZ IAS 1 prescribes a specific format entities should use when preparing a statement of financial position. This means that entities are free to select their own format, provided the information required by NZ IAS 1—other relevant accounting standards, and section 211 of the *Companies Act 1993*—is disclosed. NZ IAS 1 does however provide extensive requirements for the presentation of the statement of financial position. These include a requirement to classify items as current or non-current, specifying the minimum number of line items that should appear in the statement of financial position, and detailing those equity items that require disclosure.

As indicated in the previous paragraph, NZ IAS 1 requires separate classification of current and non-current assets and current and non-current liabilities on the face of the statement of financial position. Alternative presentations based on liquidity are acceptable, provided they are reliable and provide information which is more relevant. Whatever method of presentation is adopted, NZ IAS 1, paragraph 52, requires that

> *for each asset and liability line item that combines amounts expected to be recovered or settled (a) no more than twelve months after the balance sheet date and (b) more than twelve months after the balance sheet date, an entity shall disclose the amount expected to be recovered or settled after more than twelve months.*

10.1 Current assets and liabilities

According to the requirement of NZ IAS 1, paragraph 57, an asset must be classified as current when it satisfies any of the following criteria:

> *(a) it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;*
> *(b) it is held primarily for the purpose of being traded;*
> *(c) it is expected to be realised within twelve months after the balance sheet date; or*
> *(d) it is cash or a cash equivalent (as defined in NZ IAS 7 Cash Flow Statements) unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.*

Current assets include assets (such as inventories and trade receivables) that are sold, consumed, or realised as part of the normal operating cycle, even when they are not expected to be realised within twelve months after the balance sheet date. Assets held primarily for the purpose of being traded, as well as the current portion of non-current financial assets, can also be categorised as current assets. Non-current assets include tangible, intangible, and long-term financial assets. Within the context of paragraph 57(a) above, an entity's operating cycle is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. Where a normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months.

Detailed guidance is provided by NZ IAS 1 on how liabilities should be classified into their current and non-current portion. According to NZ IAS 1, paragraph 60, a liability must be classified as current when it meets any of the following criteria:

> *(a) it is expected to be settled in the entity's normal operating cycle;*
> *(b) it is held primarily for the purpose of being traded;*
> *(c) it is due to be settled within twelve months after the balance sheet date; or*
> *(d) the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date.*

Liabilities considered to be part of the normal operating cycle include trade payables, accruals for employee benefits, and other operating costs. As they are integral to the to the entity's operations, they are always considered as current liabilities even though their payment may occur twelve months after the balance sheet date. Consistent with the current liability requirements considered earlier, when the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months. There are also a number of liabilities that do not form part of normal operating cycle. Where any of the following are due for settlement within twelve months of the balance sheet date financial liabilities held for trading, bank overdrafts, dividends payable, income taxes payable, and non-trade payables—these should also be classified as current liabilities.

If a portion of a non-current liability is due for repayment within twelve months of the balance sheet date, then this portion should be classified as a current liability. However, if the entity expects, and has the discretion, to refinance or roll over the obligation beyond the twelve-month period after the balance sheet date, this portion is not reclassified as a current liability.

The breach of debt covenants and their effect on liabilities requires careful consideration. If, before the balance sheet date, a covenant under a long-term debt agreement is breached, the liability usually becomes payable on demand. Under these circumstances the liability must be classified as being current, even if after the balance sheet date and before the authorisation of the financial statements for issue, the lender has agreed not to call in the loan. The reason for this classification is that at the balance sheet date, the entity does not have an unconditional right to defer its settlement for at least twelve months after that date. However, if by the balance sheet date the lender has agreed to provide a period of grace ending at least twelve months after the balance sheet date, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment, the liability is classified as non-current (NZ IAS 1, paragraph 65–66).

NZ IAS 1, paragraph 68, details those line items that should appear on the face of the statement of financial position. In the sections that follow, these will be examined under the respective headings of assets, liabilities and equity.

Exhibit 18 Statement of financial position

Illustration Limited **Statement of financial position** **At 31 March 2006**	*Notes*	*2006* *$*	*2005* *$*
ASSETS			
Non-current assets			
Property, plant and equipment		XXX	XXX
Intangible assets		XXX	XXX
Goodwill		XXX	XXX
Available for sale investments		XXX	XXX
Total non-current assets		XXX	XXX
Current assets			
Inventories		XXX	XXX
Trade receivables		XXX	XXX
Cash and cash equivalents		XXX	XXX
Total current assets		XXX	XXX
Total assets		XXX	XXX
LIABILITIES			
Non-current liabilities			
Long-term borrowings		XXX	XXX
Deferred tax		XXX	XXX
Long-term provisions		XXX	XXX
Total non-current liabilities		XXX	XXX
Current liabilities			
Trade and other payables		XXX	XXX
Short term borrowings		XXX	XXX
Current portion of long-term liabilities		XXX	XXX
Current tax liabilities		XXX	XXX
Current provisions		XXX	XXX
Total current liabilities		XXX	XXX
Total liabilities		XXX	XXX
NET ASSETS		XXX	XXX
EQUITY			
Capital and reserves			
Contributed equity		XXX	XXX
Other reserves		XXX	XXX
Retained earnings		XXX	XXX
		XXX	XXX
Minority interest		XXX	XXX
Total equity		XXX	XXX

The format for the statement of financial position is based on the accounting equation:

Assets – Liabilities = Equity

The statement of financial position shown in Exhibit 18 makes use of headings and subheadings to separate the assets and liabilities into their current and non-current components. As was indicated earlier, alternative presentations are acceptable and different headings and subheadings may be appropriate, depending on the disclosure policies of the entity concerned. Professional judgement must be used in making decisions on whether additional items are presented separately in the statement of financial position. This should be based on an assessment of the nature and liquidity of assets, the function of assets within the entity, and the amounts, nature and timing of liabilities.

Items that must be disclosed in terms of NZ IAS 1 and other relevant accounting standards are described in more detail in the paragraphs under the headings assets, liabilities and equity.

10.2 Assets

Assets are defined in paragraph 49(a) of the NZ Framework as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'. Paragraph 53 of the NZ Framework identified the future economic benefits embodied in an asset as 'the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity'. This contribution may be productive, that is part of the operating activities of the entity, or alternatively, the potential of being converted into cash or cash equivalents or providing a capability to reduce future cash outflows. An example of the reduction of future cash flows would be an alternative manufacturing process which reduces the costs of production.

NZ IAS 1, paragraph 68, states that as a minimum, the following assets shall be disclosed as separate line items on the face of the statement of financial position, these are:

(a) property, plant and equipment
(b) investment property
(c) intangible assets
(d) financial assets (excluding amounts shown under (e), (h) and (i))
(e) investments accounted for using the equity method
(f) biological assets
(g) inventories
(h) trade and other receivables (a financial asset but one that requires separate disclosure)
(i) cash and cash equivalents (a financial asset but one that requires separate disclosure).

A number of these disclosures are expanded on in the sections that follow.

10.2.1 Property, plant and equipment

An entity is required to disclose a significant amount of information in relation to property, plant and equipment in their financial statements. NZ IAS 1, paragraph 75(a), requires items of property, plant and equipment to be disaggregated into their classes. What this means is that each class of an entity's property, plant and equipment requires separate disclosure. A class of property, plant and equipment is considered by NZ IAS 16, paragraph 37, as 'a grouping of assets of a similar nature and use in an entity's operations'. The individual classes of property, plant and equipment that an entity will disclose will depend on the nature of its operations. However, examples of different classes of property, plant and equipment would include: land, land and buildings, machinery, ships, aircraft, motor vehicles, furniture and fixtures, and office equipment. The information to be disclosed in financial statements is shown in Exhibit 19.

Exhibit 19 Note disclosing property, plant and equipment

Note 15 Property, plant and equipment

	Land	Buildings	Vehicles	Total
Balance at 1 April 2004				
At cost or valuation	XXX	XXX	XXX	XXX
Accumulated depreciation	XXX	XXX	XXX	XXX
Net book value	XXX	XXX	XXX	XXX
Net book value 31 March 2005				
Opening net book value	XXX	XXX	XXX	XXX
Additions	-	-	XXX	XXX
Disposals	-	-	XXX	XXX
Depreciation		XXX	XXX	XXX
Closing net book amount	XXX	XXX	XXX	XXX
Year ended 31 March 2005				
Cost or valuation	XXX	XXX	XXX	XXX
Accumulated depreciation	XXX	XXX	XXX	XXX
Net book value	XXX	XXX	XXX	XXX
Year ending 31 March 2006				
Opening book value	XXX	XXX	XXX	XXX
Additions	XXX	XXX	-	XXX
Disposals		XXX	-	XXX
Depreciation charge		XXX	XXX	XXX
Closing book value	XXX	XXX	XXX	XXX
At 31 March 2006				
Cost or valuation	XXX	XXX	XXX	XXX
Accumulated depreciation	XXX	XXX	XXX	XXX
Net book value	XXX	XXX	XXX	XXX

Buildings shown at cost have a fair value that approximates cost. The fair values determined by director's valuation were based on a general review of market conditions since the date of purchase.
Land is revalued every three years. Land shown at valuation was revalued to $XXX by A. Smith, MIV, an independent valuer on 13 October 2003, on the basis of fair value.

Land and buildings have been mortgaged in respect of the term loan (Note 15).

Depreciation is calculated on the straight-line basis (NZ IAS 16, 73(b) and (c)) at the following rates:

Buildings	2 per cent per annum
Plant and machinery	15 per cent per annum
Motor vehicles	25 per cent per annum

Exhibit 19 provides the information from NZ IAS 16, paragraph 77, which requires entities to disclose. As can be seen from the exhibit, for each class of asset, the balance at the beginning of the period is reconciled with the balance at the end of the period. In this reconciliation the following disclosure should include:

- additions
- assets classified as held for sale
- acquisitions through business combinations
- increases or decreases resulting from revaluations
- impairment losses recognised in profit or loss
- impairment losses reversed in profit or loss
- depreciation
- the net exchange differences arising from the translation of the financial statements from the functional currency into a different presentation currency
- other changes.

A number of entities have persisted in detailing the depreciation rates used to allocate costs to items of property, plant and equipment in the accounting policy note. That this treatment would be considered incorrect under NZ IAS 1 is confirmed by paragraph 113, which states:

> *An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 116), management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.*

It is submitted that Exhibit 19 discloses the information relating to depreciation in the correct way. The accounting policy would be to depreciate the assets over their useful life and this would be disclosed in the accounting policy note. The rates used are not an accounting policy

but merely the estimate used by the entity to allocate the future economic benefits embodied in the asset that are consumed principally through its use. As such it is appropriate to show these in the property, plant and equipment note. Changes in depreciation rates are not accounted for as changes in accounting policy, but as a change in an accounting estimate.

NZ IAS 16, paragraph 77, requires that where an item of property, plant and equipment is recorded at a revalued amount, the following information should be provided:

- the effective date of the revaluation
- whether an independent valuer was involved
- the methods and significant assumptions applied in estimating the items' fair values
- the extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques
- for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model
- the revaluation surplus, indicating the change for the period, and any restrictions on the distribution of the balance to shareholders.

In addition, NZ IAS 16, paragraph 77.2, requires certain additional information be provided. This includes the name of the valuer as well as disclosing whether the valuer is an employee of the entity or an independent valuer. The total fair value of property, plant and equipment valued by that valuer should also be provided. Where the valuation has been conducted by an employee of the entity, the name of the independent valuer who reviewed the valuation, and finally, the date(s) of the valuations should be disclosed. If an independent valuer has not been used to value an item of property, plant and equipment because there is an active market, or readily available price, indices that establish the fair value NZ IAS 16, paragraph 77.3, requires this information to be disclosed.

NZ IAS 16 introduces a new disclosure requirement relating to property, plant and equipment. In paragraph 79, the statement suggests that users of the financial statements would find it useful if the following information were also disclosed:

- the carrying amount of temporarily idle property, plant and equipment
- the gross carrying amount of any fully depreciated property, plant and equipment that is still in use
- the carrying amount of property, plant and equipment retired from active use and held for disposal

- ♦ when the cost model is used, the fair value of property, plant and equipment, when this is materially different from the carrying amount.

It is possible that a number of different measurement bases could be used to value item of property, plant and equipment. For example, some items may be carried at historical cost, while other items may be carried at fair value. Where this has occurred, NZ IAS 1, paragraph 73, suggests that these items should be shown as separate line items on the statement of financial position.

Additional specific disclosures relating to property, plant and equipment are required to be provided in financial statements. For example, NZ IAS 16, paragraph 74(a), requires entities to disclose the existence and amounts of restrictions on title, and property, plant and equipment pledged as security. These disclosures cover items including mortgages, fixed and floating charges and restrictions associated with Treaty of Waitangi claims. They do not cover items such as rights of way. Examples of notes meeting these additional disclosure requirements are the mortgage note over land and buildings in respect of the term loan shown in Exhibit 19. A further example of a note envisaged by NZ IAS 16, paragraph 74(a), might read: 'The loan has been secured by a floating charge over the company's assets'.

NZ IAS 16 also includes a number of additional disclosures that are important for preparers of financial statements to take into account. These include the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction; and the amount of contractual commitments for the acquisition of property, plant and equipment. Finally, NZ IAS 16, paragraph 74(d), requires the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost, or given up, are included in profit or loss to be disclosed if it is not shown separately on the face of the income statement.

10.2.2 Intangibles

Intangible assets are usually disclosed in the statement of financial position as non-current assets. They are grouped into various classes. A class of intangible assets can be described as a grouping of assets of a similar nature and use in an entity's operations. Examples of different class of intangibles include patents and other industrial property rights, trademarks, brand names, mastheads and publishing titles, copyrights, record masters, computer software, licences and franchises, service and operating rights, recipes, formulas, models, designs and prototypes, intangible assets under development, and goodwill.

NZ IAS 1, paragraph 68(c), requires intangible assets to be disclosed as a separate line item on the statement of financial position. Further disclosure guidelines are provided in the

illustrative statement of financial position shown in the 'Guidance on Implementing IAS 1'. Intangible assets are split into goodwill and other intangible assets. So as to be consistent with the suggested guidance, this section splits intangible assets into goodwill and other intangibles.

10.2.3 Intangible assets

Subject to the exceptions contained in NZ IAS 38 'Intangible Assets', relating to development assets, only purchased intangible assets are disclosed in financial statements. Internally generated intangible assets in the form of brands, mastheads, publishing titles, customer lists and items similar in substance are not recognised as intangible assets in an entity's financial statements, as the amount used to develop them usually cannot be isolated from other costs of developing the business.

Detailed disclosure requirements for intangible assets are found in NZ IAS 38. The accounting standard requires entities disclose a variety of items for each class of intangible asset, in addition to distinguishing between internally generated (subject to the limitations considered above) and other intangible assets. In particular, for each class of intangible asset, paragraph 118 requires entities to disclose:

> *(a) whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;*
> *(b) the amortisation methods used for intangible assets with finite useful lives;*
> *(c) the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;*
> *(d) the line item(s) of the income statement in which any amortisation of intangible assets is included;*
> *(e) a reconciliation of the carrying amount at the beginning and end of the period showing:*
> > *(i) additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;*
> > *(ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with NZ IFRS 5 and other disposals;*
> > *(iii) increases or decreases during the period resulting from revaluations under paragraphs 75, 85 and 86 and from impairment losses recognised or reversed directly in equity in accordance with NZ IAS 36 Impairment of Assets (if any);*
> > *(iv) impairment losses recognised in profit or loss during the period in accordance with NZ IAS 36 (if any);*
> > *(v) impairment losses reversed in profit or loss during the period in accordance with NZ IAS 36 (if any);*
> > *(vi) any amortisation recognised during the period;*

(vii) net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and

(viii) other changes in the carrying amount during the period.

The disclosure requirements contained in paragraph e(i)–(viiii) are consistent with the disclosure requirement for property, plant and equipment. A comparison of Exhibits 19 and 20 illustrates the similarities between the disclosures of the different assets.

10.2.4 Goodwill

Only purchased goodwill is disclosed in the financial statements of an entity. Goodwill arises when one entity acquires another entity, or part of an entity. For example, if one company acquires a controlling interest in another entity (the acquired entity becoming a subsidiary) then goodwill might arise. Goodwill is the excess of the cost of acquisition of an entity over the fair value of any net assets acquired.

Goodwill itself is an unidentifiable intangible asset. It cannot be individually identified, and is an intrinsic part of the business. This means that it cannot be purchased or sold separately but only as part of an entity as a whole. Goodwill represents the future economic benefits associated with an existing customer base, efficient management, reliable suppliers and the like. However, each of these individual factors is not usually separately valued or identified within an entity's statement of financial position. Rather, they are typically combined in the composite asset—goodwill. Miller (1995, p. 7) provides a useful definition of goodwill:

> *Goodwill is a different type of asset: it is not a discreet resource but a plug representing the excess of an entity's value as a totality over the aggregate of the individual values of its net assets. It often arises from the way the physical assets and human resources of the acquired business have been arranged and coordinated in relation to environmental conditions and may be attributed to such factors as market penetration, an excellent distribution network, good industrial relations and superior management.*

Goodwill might be built up over a number of periods or it might be obtained by acquiring an existing business. Many individuals or organisations buy businesses with the intention of making them successful and then selling them at a higher price taking into account the goodwill that they might have built up within the business.

Goodwill might be internally generated or acquired by purchasing an existing business. Within New Zealand, internally generated goodwill may not be brought to account. This is because purchased goodwill can be measured more objectively on the basis of the amount paid for it than internally generated goodwill, which is not capable of being reliably measured. Consequently, the accounting treatment for purchased goodwill differs from that

for internally generated goodwill. This is confirmed by NZ IAS 38, paragraph 49, which states:

> *Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (ie it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.*

Purchased goodwill is measured as the excess of the cost of acquisition (purchase consideration plus incidental expenses) incurred by the acquirer over the fair value of the recognised identifiable assets and liabilities acquired. Fair value is defined as the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's-length transaction. Purchase consideration is measured at the fair value of what is given up in exchange.

The overriding goodwill disclosure requirements are straightforward. NZ IFRS 3 'Business Combinations' paragraph 74, requires that sufficient information be disclosed that will enable users to evaluate changes in the carrying amount of goodwill during the period. The detailed disclosure requirements that give effect to the requirements is provided by paragraph 75. This paragraph required the balance of goodwill at the beginning of the period to be reconciled to the balance at the end of the year. The following items require separate disclosure in the reconciliation:

- the gross amount and accumulated impairment losses at the beginning of the period
- additional goodwill recognised during the period
- adjustments resulting from the subsequent recognition of deferred tax assets during the period
- goodwill included in a disposal group classified as held for sale and goodwill derecognised during the period without having previously been included in a disposal group classified as held for sale
- impairment losses recognised during the period
- net exchange differences arising during the period
- any other changes in the carrying amount during the period
- the gross amount and accumulated impairment losses at the end of the period.

A comparison of the above detailed disclosure requirement with those required for property, plant and equipment, and other intangible assets illustrates their similarity.

Exhibit 20 Disclosure of intangibles

Note 16 Intangible assets

	Goodwill	Patents and trademarks	Licences	Total
Balance at 1 April 2004				
At cost	XXX	XXX	XXX	XXX
Accumulated amortisation and impairment	XXX	XXX	XXX	XXX
Net book value	XXX	XXX	XXX	XXX
Net book value 31 March 2005				
Opening net book value	XXX	XXX	XXX	XXX
Additions	-	-	XXX	XXX
Impairment charge	XXX	-	-	XXX
Amortisation charge	-	XXX	XXX	XXX
Closing net book amount	XXX	XXX	XXX	XXX
Year ended 31 March 2005				
Cost or valuation	XXX	XXX	XXX	XXX
Accumulated amortisation and impairment	XXX	XXX	XXX	XXX
Net book value	XXX	XXX	XXX	XXX
Year ending 31 March 2006				
Opening book value	XXX	XXX	XXX	XXX
Additions	XXX	XXX	-	XXX
Disposals		XXX	-	XXX
Impairment charge	XXX	-	-	XXX
Amortisation charge	-	XXX	XXX	XXX
Closing book value	XXX	XXX	XXX	XXX
At 31 March 2006				
Cost or valuation	XXX	XXX	XXX	XXX
Accumulated amortisation and impairment	XXX	XXX	XXX	XXX
Net book value	XXX	XXX	XXX	XXX

10.2.5 Financial assets

In the context of this section, NZ IAS 32, paragraph 11, defines a financial asset as an equity instrument of another entity. A financial asset is defined in NZ IAS 32 as any asset that is:

(a) cash;
(b) an equity instrument of another entity;
(c) a contractual right:
 (i) to receive cash or another financial asset from another entity; or
 (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
(d) a contract that will or may be settled in the entity's own equity instruments and is:

> *(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or*
>
> *(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.*

This is a very broad definition and encompasses a wide variety of financial assets. From the definition it is clear that financial assets include, (but are not limited to): investments in central government and local body stock, secured loans (including debentures), rights or interests in business undertakings, and other investments.

Where entities make what they consider to be 'strategic investments' in equity instruments issued by other entities, their intention is generally to establish or maintain a long-term operating relationship with the entity in which the investment has been made. For the purposes of this publication, the investments in equity instruments considered here are those less than the threshold required for NZ IAS 28 'Investments in Associates' to be applied. Consistent with the definition of equity in the NZ Framework, an equity instrument is defined in NZ IAS 32, paragraph 11, as 'any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities'.

10.2.6 Categories of financial assets

From the definition of financial assets in paragraph 11, four categories of financial assets are identified in NZ IAS 39. These are:

- financial asset at fair value through profit and loss
- held-to-maturity investments
- loans and receivables
- available-for-sale financial assets.

Although each category is assigned a measurement principal, only the disclosure and certain re-measurement issues relating to financial asset or financial liability at fair value through profit and loss, and available-for-sale financial assets, are considered here. More detailed information on financial instruments can be found in Deegan and Samkin, *New Zealand Financial Accounting 2e*.

10.2.6.1 Financial assets at fair value through profit and loss

A financial asset at fair value through profit and loss is a financial asset that meets either of the conditions detailed in NZ IAS 39, paragraph 9. These are:

> *(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:*
> *(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;*
> *(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or*
> *(iii) a derivative (except for a derivative that is a designated and effective hedging instrument).*
>
> *(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. Any financial asset or financial liability within the scope of this Standard may be designated when initially recognised as a financial asset or financial liability at fair value through profit or loss except for investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81).*

Trading generally reflects active and frequent buying. A financial instrument is considered to be held for trading, if the entity's principle purpose in acquiring the asset was to hold it with the objective of generating a profit. This profit can arise either through short-term gains (from price fluctuations) or a dealer's margin, or if the asset is part of a portfolio of identified instruments that are managed together and for which there is evidence of a recent pattern of short-term profit taking.

Trading assets include debt and equity securities, loans and receivables that have been acquired by an entity with the intention of making a short profit. Trading assets are initially recognised at cost. At each balance sheet date they must be re-measured at fair value until the asset is derecognised. When considering trading assets, fair value is generally determined by reference to an active market. In NZ IAS 39, paragraph AG71 provides guidance on when financial instruments would generally be regarded as quoted in an active market. This occurs

> *if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those process represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction.*

Any gains or losses arising from the revaluation must be recognised in the statement of financial performance in the period in which they occur.

Certain difficulties arise if the trading asset relates to an equity instrument that does not have a quoted market price in an active market. This means that its fair value cannot be reliably measured. While it may be possible to estimate the fair value of these financial assets under certain circumstances, (for example if the asset has recently been acquired from an outside party), this is not always the case. Where there is a wide range of possible fair values which cannot be reasonably assessed, an entity must measure these assets at cost.

Where financial assets are held primarily for the purpose of being traded, NZ IAS 1, paragraph 60(b), requires them to be classified as a current asset in the statement of financial position.

10.2.6.2 Available-for-sale financial assets

Available-for-sale financial assets are defined in NZ IAS 39, paragraph 9, as being those financial assets that are designated as available-for-sale and not classified as loans and receivables, held-to-maturity investments, or financial assets at fair value through profit or loss. Essentially this category is a residual category which includes all equity securities except those classified as trading.

Financial assets classified as available-for-sale must be initially recognised and disclosed in the financial statements at their fair value. At each balance sheet date, the available-for-sale financial asset must be re-measured to fair value. Other than certain exceptions (relating to impairment losses and foreign exchange gains and losses, and which are outside the scope of this publication) any gains or losses resulting from the re-measurement must be taken directly to equity through the statement of changes in equity. Any interest calculated using the effective interest method, or dividends on an available-for-sale equity instrument, are recognised in the statement of financial performance when the entity's right to receive payment is established.

It should be noted that an entity is not required to use these categories as descriptions in financial statements. Other descriptors or categorisations could be used when presenting information on the face of the financial statements. This is illustrated in the note covering financial assets in Exhibit 21. Whether a financial asset is designated as a financial asset held at fair value through profit and loss, or an available-for-sale financial asset, will depend on managements' intentions.

Exhibit 21 Disclosure of financial assets

	2006 *$*	*2005* *$*
Note 17 Investments		
Financial assets available-for-sale		
Balance at beginning of year	XXX	XXX
Additions	XXX	XXX
Revaluation surplus recognised in statement of changes in equity	XXX	XXX
Balance at end of year	XXX	XXX
Financial assets available-for-sale include the following:		
Equity securities – New Zealand	XXX	XXX
Investment in Government stock	XXX	XXX
	XXX	XXX
Financial assets at fair value through profit and loss		
Balance at beginning of year	XXX	XXX
Additions	XXX	XXX
Revaluation surplus recognised in profit for the year	XXX	XXX
Balance at end of year	XXX	XXX
Financial assets at fair value through profit and loss include the following:		
Listed investments		
Equity securities – Australia	XXX	XXX
Fixed interest 4% debentures – maturity date 30 September 2011[1]	XXX	XXX
6% non-cumulative non-redeemable preference shares[2]	XXX	XXX
	XXX	XXX
Unlisted investments		
Equity securities of private issuers	XXX	XXX
Total available-for-sale financial assets	XXX	XXX

[1] Effective interest rate 5.1 per cent
[2] Effective interest rate 6.1 per cent

10.2.7 Receivables

NZ IAS 1, paragraph 75(b), details those receivables that should be specifically disclosed in the statement of financial position. These include amounts receivable from trade customers, receivables from related parties, prepayments and other amounts. The individual receivables should be disaggregated so that users of the financial statements are able to distinguish between individual items. It is also important to remember that trade and other receivables are classified as financial assets. As such, the measurement and disclosure issues contained in other financial reporting standards namely, NZ IAS 32 'Financial Instruments: Disclosure and Presentation', NZ IAS 39, 'Financial Instruments: Recognition and Measurement', and NZ IAS 36 'Impairment of Assets', must be considered. Although the majority of the

measurement and disclosure requirements relating to financial instruments are outside the scope of this book, those relating to trade and other receivables are relevant. Where trade receivables have been impaired, for example, a provision for bad debts exists, NZ IAS 32, paragraph 94(i), requires this impairment loss to be separately recognised. In addition, NZ IAS 36, paragraph 126(a), requires the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the income statement in which those impairment losses are included, to be disclosed. While these additional requirements may appear onerous, they are consistent with the requirements previously contained in FRS-9.

Important new disclosure requirements face New Zealand entities with the adoption of international accounting standards. NZ IAS 32, paragraph 86, requires entities to disclose the fair value of each class of financial asset to be disclosed in such a way so that it can be compared to the corresponding value in the statement of financial position. An example of the disclosures envisaged by NZ IAS 1 and other accounting standards is detailed in Exhibit 22.

Exhibit 22 Disclosure of trade and other receivables

	2006 *$*	*2005* *$*
Note 13 Trade and other receivables		
Trade receivables	XXX	XXX
Less provision for bad debts	(XXX)	(XXX)
	XXX	XXX
Prepayments	XXX	XXX
Related party receivables	XXX	XXX
Total receivables	XXX	XXX
Fair value of trade and other receivables		
Trade receivables	XXX	XXX
Prepayments	XXX	XXX
Related party receivables	XXX	XXX
	XXX	XXX

An amount of $XXX (2005 - $XXX) has been recognised as an impairment for trade receivables for the year. This amount is included in selling and marketing expense in the statement of financial performance.

While amounts receivable from trade customers and prepayments requires no further explanations, the term ‘receivables from related party’ requires further elucidation. At this stage is should be mentioned that related party relationships giving rise to related party receivables are a normal feature of commerce and business. Related party receivables arise because many entities carry on part of their activities through subsidiaries, joint ventures and

associates. Where these activities occur through these vehicles, an entity may through control, joint control or significant influence, have the ability to influence the financial and operating policies of the investee.

10.2.8 Related party transactions

Related party transactions may also have an impact on the profit or loss and/or the financial position of an entity. This occurs because it is possible for related parties to enter into commercial transactions that parties who are not related to the entity are unable to. An example of this would include the sale of goods to a parent entity at cost, or on terms not available to other customers. Equally, the mere existence of a related party relationship may be sufficient to affect the transactions of the entity with other parties. An example of this would include a subsidiary terminating business relations with a trading partner, on acquisition by the parent of a fellow subsidiary engaged in the same activity as the former trading partner.

It is for these reasons that knowledge of related party transactions, outstanding balances and relationships are disclosed in financial statements. These relationships may affect how users assess an entity's operations, including the risks and opportunities facing the entity.

According to paragraph 9 of NZ IAS 24 'Related Party Disclosures', related parties include:

> *(a) those parties who are directly or indirectly controls, is controlled by, or under common control with, the entity (including parent entities, subsidiaries and fellow subsidiaries), has an interest that gives it significant influence, or has joint control over an entity;*
> *(b) associates;*
> *(c) a venturer in a joint venture;*
> *(d) a member of key management personnel of the entity or its parent (usually executive and non-executive directors);*
> *(e) a close family member of any individual referred to in (a) to (d) above;*
> *(f) an entity that is controlled, jointly controlled or significantly controlled by or for, or significant voting power in this entity resides directly or indirectly with any individual referred to in (d) or (e); or*
> *(g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.*

What this suggests is that where transactions have occurred between the entity reporting and its related parties, and receivables remain to be settled at balance date, these balances should be disaggregated and separately disclosed. While the identity of a number of related parties is self-explanatory, the term 'close family member' requires some amplification here. Under NZ IAS 24, close family members are those family members who may influence, or be influenced by, that individual in their dealings with the entity. These include the individual's domestic

partner and children; children of the individual's domestic partner; and dependants of the individual or the individual's domestic partner.

The minimum disclosures that should be provided for receivables from related parties can be found in NZ IAS 24, paragraph 17. This paragraph requires that where there have been transactions between related parties, 'the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements' must be provided. These minimum disclosures should include:

(a) the amount of the transactions;
(b) the amount of outstanding balances and:
  (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
  (ii) details of any guarantees given or received;
(c) provisions for doubtful debts related to the amount of outstanding balances; and
(d) the expense recognised during the period in respect of bad or doubtful debts due from related parties.

Exhibit 23 illustrates how these disclosure requirements can be applied to a specific receivable from a related party, namely loans to directors. In this exhibit, the minimum disclosure requirement of NZ IAS 27, paragraph 24, have been supplemented by additional information enabling users of the financial statements to the have a complete understanding of this particular receivable.

Exhibit 23 Disclosure of loans to directors

	2006	*2005*
	$	*$*
Note 22 Loans to directors		
Mr A. Smith		
Balance 1 April 2005	XXX	XXX
Advances during the year	XXX	XXX
Balance 31 March 2006	XXX	XXX

The loan is unsecured. Interest is payable at 4 per cent per annum.
The loan is repayable in full on 15 November 2011.

Mr Y. Jones		
Balance 1 April 2005	XXX	XXX
Advances during the year	XXX	XXX
	XXX	XXX
Repayments made during the year	XXX	XXX
Write-down of loan	XXX	XXX
Balance 31 March 2006	XXX	XXX
Total loans	XXX	XXX

The loan is secured over accrued long-service leave and share options. Interest is payable at 8 per cent per annum. The loan is repayable in equal instalments ending on 12 October 2012.

This exhibit clearly details the amounts of the individual transactions that occurred during the year. Balances outstanding on the loan at the beginning and end of the year are detailed. The terms and conditions of the loans as required by NZ IAS 24, paragraph 17(b)(i) and (ii)are specifically provided.

10.2.9 Inventories

The majority of supplementary information relating to inventories is disclosed in the accompanying notes. For example, a note accompanying the inventories figure would, if appropriate, separate inventories into current and non-current components, with the carrying amount of inventories in each category being disclosed. The majority of inventories would, however, normally be disclosed as a current asset.

NZ IAS 1, paragraph 75(c), requires inventories to be subclassified, in accordance with NZ IAS 2 'Inventories'. According to NZ IAS 2 'Inventories', paragraph 36(b), the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity should be disclosed. This is usually achieved by classifying inventories as merchandise, production supplies such as raw materials, work in progress, and finished goods. Where inventories have been specifically and separately pledged as securities for liabilities, or are subject to retention of title clauses—this must be disclosed (NZ IAS 2, 36(h)).

Exhibit 24 Note disclosing inventories

	2006 *$*	*2005* *$*
Note 14 Inventories		
Raw materials	XXX	XXX
Consumable stores	XXX	XXX
Work in progress	XXX	XXX
Finished goods	XXX	XXX
Total inventory	XXX	XXX

The cost of inventories recognised as expenses and included in 'cost of goods sold' amounts to $XXX (2005 – $XXX).
Inventories to the value of $XXX (2005 – $XXX) are subject to a retention of title clause.

There are a number of additional disclosures required by NZ IAS 2, paragraph 36. These are:

(a) the accounting policies adopted in measuring inventories, including the cost formula used;
(b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;
(c) the carrying amount of inventories carried at fair value less costs to sell;

(d) the amount of inventories recognised as an expense during the period;
(e) the amount of any write-down of inventories recognised as an expense in the period;
(f) the amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period;
(g) the circumstances or events that led to the reversal of a write down of inventories; and
(h) the carrying amount of inventories pledged as security for liabilities.

An example of the NZ IAS 2, paragraph 36(h), disclosure often referred to as a Romalpa clause, can be found in Exhibit 24 above.

10.2.10 Cash and cash equivalents

The term cash is self explanatory. It generally refers to cash on hand and demand deposits. Cash equivalents are defined by NZ IAS 7, paragraph 6, as 'short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value'.

According to NZ IAS 7, cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. Cash equivalents, which exclude equity investments, have short term maturity, which is generally less than three months from the date of their acquisition. This short term maturity means that there is an insignificant risk of any changes in value. If a bank overdraft is repayable on demand, it should be treated as a component of cash and cash equivalent, while bank borrowings are generally viewed as being a component of an entity's financing activities.

10.3 Liabilities

Users of financial statements are interested in the extent to which entities have borrowed money or incurred debt in order to conduct their operations. The more money an entity has borrowed, the greater the possible risk of it defaulting on loans. So that users of financial statements can assess the level of risk associated with various liabilities, and to ensure that all liabilities are recognised, extensive disclosures are required. Liabilities are defined in the NZ Framework, paragraph 49(b), as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'

NZ IAS 1, paragraph 68, states that as a minimum, the following liabilities shall be disclosed as separate line items on the face of the statement of financial position, these are:

(j) trade and other payables (a financial liability but one that requires separate disclosure)

(k) provisions (a financial liability but one that requires separate disclosure)

(l) financial liabilities (excluding amounts shown under (j) and (k))

(n) deferred tax liabilities and deferred tax assets, as defined in NZ IAS 12.

Limited guidance is provided in NZ IAS 1 on how these items (especially those relating to trade and other parables), and provisions should be disclosed. However, it should be remembered that paragraph 69 required entities to include additional line items, headings and subtotals on the face of the statement of financial position where this is relevant for users to obtain an understanding of the entity's financial position. Other than deferred tax liabilities (and assets) which is considered in more detail in the accompanying text, *New Zealand Financial Accounting 2e*, each of these disclosures in (j) to (l) is expanded on in the section on liabilities below.

10.3.1 Financial liabilities

NZ IAS 1, paragraph 68(l), requires the disclosure of financial liabilities. A financial liability is defined in NZ IAS 32, paragraph 11, as any liability that is:

> (*a*) *a contractual obligation:*
> (*i*) *to deliver cash or another financial asset to another entity; or*
> (*ii*) *to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or*
> (*b*) *a contract that will or may be settled in the entity's own equity instruments and is:*
> (*i*) *a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or*
> (*ii*) *a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.*

As with financial assets, the definition of financial liabilities encompasses a wide variety of items, including but are not limited to long and short term loans payable, notes payable, and bonds (debentures) payable. For a financial liability to exist there must be a contractual obligation to deliver cash in the future. Although NZ IAS 1 refers to financial liabilities, entities generally use the term borrowings to describe financial liabilities.

The financial liability disclosures contained in NZ IAS 32 are more extensive than those previously required by FRS-9. While it is not possible in a publication such as this to provide all the disclosure requirements, the following disclosures are relevant. Essentially where financial liabilities exist for each class, an entity is required to disclose information about contract repricing, or maturity dates, whichever is earlier (NZ IAS 32, paragraph 67(a)) and the effective interest rates (NZ IAS 32, paragraph 67(b)). As with the requirements for financial assets, an entity must disclose the fair value of each class of financial liabilities in

such a way that it can be compared to the corresponding amount in the statement of financial position (NZ IAS 32, paragraph 86). (Guidance for determining fair value is provided in NZ IAS 39, but is outside the scope of this publication.) The methods and significant assumptions applied in determining the fair values of the financial liabilities must be provided.

Any additional information that may be relevant in assisting users in understanding the financial position and liquidity of any entity should also be provided. This includes information on the amount of undrawn borrowing facilities available for future operating activities and to settle capital commitments, as well as any restrictions on the use of these facilities; (NZ IAS 7, 'Cash Flow Statements', paragraph 50(a)).

Finally, entities should disclose information about its exposure to interest rate risk for each class of financial liability. This includes (NZ IAS 32, paragraph 67), contractual repricing or maturity dates, whichever dates are earlier; and when applicable, effective interest rates. A typical example is given in Exhibit 25.

Exhibit 25 Disclosure of borrowings

	2006 *$*	*2005* *$*
Note 19 Borrowings		
Non-current		
Long-term loans	XXX	XXX
Debentures	XXX	XXX
Liabilities under finance lease	XXX	XXX
Current		
Bank overdraft	XXX	XXX
Current portion of long-term loans	XXX	XXX
Current portion of liabilities under finance lease	XXX	XXX
	XXX	XXX
Total borrowings	XXX	XXX
The fair values of the non-current borrowings are as follows:		
Long-term loans	XXX	XXX
Debentures	XXX	XXX
Liabilities under finance lease	XXX	XXX
	XXX	XXX
The fair values are based on the cash flows discounted at the borrowing rate of 5.6% (2005 – 5.7%)		
The effective interest rates at the balance sheet date were as follows:		
Bank overdraft	8.2%	7.4%
Long-term loans	5.6%	5.7%
Debentures	7.7%	7.9%

The long-term loan is secured by way of a mortgage bond over the company's land and buildings (Note 15). The bank overdraft is secured over trade receivables (Note 13).

10.3.2 Deferred taxation

As indicated earlier in this publication, the tax expense shown in the statement of financial performance is made up of a current tax and deferred tax component. A credit balance (or deferred tax liability) implies that tax has been incurred (current tax) but has not yet been charged by the IRD. Essentially the amount is shown as owing, although it will only be recognised as an expense when the liability is reversed, sometime in the future. A debit balance implies that tax has been charged but not yet incurred. This amounts to a prepayment of tax in the current period which will be recognised as a deduction from the tax expense when it is reversed sometime in the future.

NZ IAS 12 adopts what is known as the 'balance sheet approach' to inter-period tax allocation. This approach focuses on the recognition of assets and liabilities in the statement of financial position to ensure that the correct levels of future tax benefits, and sacrifices

arising from the differences between the accounting and tax values of assets and liabilities, are recognised. The reason for focusing on the statement of financial position is that this approach is considered to be consistent with the NZ Framework and other conceptual framework projects.

The balance-sheet approach to accounting for taxation compares the *carrying value* of an entity's assets and liabilities (determined in accordance with accounting rules) with the *tax base* for those assets and liabilities. The tax base is the amount attributed to that asset or liability for tax purposes. What this means is that the balance sheet derived using accounting rules is compared with the balance sheet derived using taxation rules. The difference between the carrying value and the tax base is known as a temporary difference. The deferred tax liability or asset is determined by applying the current tax rate to the temporary difference.

Although the issue of deferred tax is more fully explored in Chapter 17 of the accompanying text, *New Zealand Financial Accounting 2e*, Exhibit 26 provides an example of the detailed disclosure requirements contained in NZ IAS 12.

Exhibit 26 Note supporting deferred taxation

	2006	*2005*
	$	*$*
Note 21 Deferred taxation		
The movements on the deferred tax account are as follows:		
Balance at beginning of year	XXX	XXX
Income statement charge	XXX	XXX
Tax charged to equity	XXX	XXX
Balance at end of year	XXX	XXX

The movements in deferred tax assets and liabilities during the year without taking into account the offsetting of balances

Deferred tax liabilities

	Accelerated tax depreciation	Fair value gains	Other	Total
Balance at 1April 2004	XXX	XXX	XXX	XXX
Charged to statement of financial performance	XXX	-	XXX	XXX
Charged to equity	-	XXX	-	XXX
Balance at 31 March 2005	XXX	XXX	XXX	XXX
Charged to statement of financial performance	XXX	-	XXX	XXX
Charged to equity	-	XXX	-	XXX
Balance at 31 March 2006	XXX	XXX	XXX	XXX

Deferred tax assets

	Impairment losses	Tax losses	Other	Total
Balance at 1April 2004	XXX	XXX	XXX	XXX
Charged to statement of financial performance	XXX	-	XXX	XXX
Balance at 31 March 2005	XXX	XXX	XXX	XXX
Charged to statement of financial performance	-	(XXX)	XXX	XXX
Balance at 31 March 2006	XXX	XXX	XXX	XXX

The deferred tax charged to equity during the year is made up as follows:

	2006	*2005*
Fair value reserves in equity		
Land	XXX	-
Revalued property and equipment	XXX	XXX
Available-for-sale financial asset	XXX	XXX
	XXX	XXX

Deferred tax assets are recognised for amounts of tax loss carried forward to the extent that the realisation of the related tax benefit through future taxable profits is probable.

10.3.3 Provisions

NZ IAS 1 is largely silent regarding the disclosure of provisions. Other than requiring their separate disclosure (paragraph 68(k)) in the statement of financial position, the only other reference to provisions which is of relevance to this section is found in paragraph 75(d). This paragraph requires provisions to be disaggregated into provisions for employee benefits and other items.

A provision is defined in NZ IAS 37, 'Provisions, Contingent Liabilities and Contingent Assets', as a liability of uncertain timing or amount. The uncertainty relates to the timing or amount of the future expenditure the entity must make to settle the provision. Provisions can be distinguished from other liabilities such as trade payables and accruals. Trade payables are liabilities that arise from the supply of goods or services that have been received and have been invoiced by the supplier. Accruals on the other hand are liabilities arising from the supply of goods or services received, but have not yet been invoiced by the supplier. Amounts due to employees for example, amounts relating to accrued holiday, long service or sick pay are included in accruals. Although it is necessary to estimate the amount or timing of accruals their uncertainty is generally less than for provisions.

The detailed provision disclosure requirements are found in NZ IAS 37. For each class of provision, entities are required to disclose:

- ♦ the carrying amount at the beginning and end of the period
- ♦ additional provisions made in the period, including increases to existing provisions
- ♦ amounts used (i.e. incurred and charged against the provision) during the period
- ♦ unused amounts reversed during the period
- ♦ the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Entities are not required to provide comparative information. Additional disclosure requirements can be found in NZ IAS 37, paragraph 85. This paragraph requires entities to disclose the following for each class of provision:

> *(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;*
>
> *(b) an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph 48; and*
>
> *(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.*

If the provisions have a current portion, this must be separately disclosed. An example of the disclosure of provision, where a current portion exists, can be found in Exhibit 27 below.

Exhibit 27 Disclosure of provisions

Note 18 Provisions

	Employee benefits	Restruct-uring	Environ-mental restoration	Total
Balance at 1 April 2005	XXX	-	XXX	XXX
Charged to income statement				
– Additional provision	XXX	XXX	XXX	XXX
– Used during the year	(XXX)	(XXX)	-	(XXX)
– Unused amounts reversed		-	(XXX)	(XXX)
Balance at 31 March 2006	XXX	XXX	XXX	XXX
Included in current liabilities				XXX
Included in non-current liabilities				XXX
				XXX

10.3.4 Trade and other payables

Trade and other payables would include items such as trade creditors, amounts payable to associates and inter-entity (where they have not been eliminated on consolidation), related parties, and other accruals for operating costs. An example of this kind of disclosure is detailed in Exhibit 28.

Exhibit 28 Disclosure of trade and other payables

	2006 *$*	*2005* *$*
Note 18 Trade and other payables		
Accounts payable	XXX	XXX
Amounts due to related parties	XXX	XXX
Accrued expenses	XXX	XXX
	XXX	XXX

10.4 Unrecognised contractual commitments

Unrecognised contractual commitments that are not yet recognised as liabilities in the statement of financial position usually relate to future capital expenditure (NZ IAS 1, paragraph 105(d)(i)). These unrecognised contractual commitments should be disclosed in the notes accompanying the financial statements. The rationale for disclosing this information is to provide users of the financial statements with an indication of potential future cash outflows. With this in mind, it is unclear why NZ IAS 1 does not require this information to

be split into the periods the outflows are likely to occur, as is required where an entity has non-cancellable operating or financing lease commitments. If providing information about cash flows is the objective, clearly providing details of expenditure payable within one year, within one to two years, within two to five years, and later than five years would assist in this respect.

Although not required by NZ IAS 1, for the sake of completeness the sources of finance used to fund the future contractual commitments should be provided. For the information on future capital expenditure to be useful, it should detail the sources of finance that will be used to fund the unrecognised capital commitments. For example, users would be interested in whether the financing will be obtained from internal funding, external borrowings or the issue of additional equity.

10.5 Discontinued operations

Where non-current assets are classified as held for sale (i.e. disposal), these are required to be disclosed separately from other assets in the statement of financial position. This provision also applies to liabilities classified as held for sale. These assets and liabilities cannot be offset and shown as a single amount. This recommended disclosure is shown in Exhibit 29.

Exhibit 29 Extract of statement of financial position illustrating the disclosure of held for sale assets and liabilities

XYZ Limited
Statement of financial position (Extract)

At 31 March 2006	*Notes*	*2006* $	*2005* $
Current assets			
Inventories		XXX	XXX
Trade receivables		XXX	XXX
Cash and cash equivalents		XXX	XXX
Total current assets		XXX	XXX
Non-current assets classified as held for sale		XXX	XXX
Total assets		XXX	XXX
Current liabilities			
Trade and other payables		XXX	XXX
Current portion of long-term liabilities		XXX	XXX
Current tax liabilities		XXX	XXX
Current provisions		XXX	XXX
Total current liabilities		XXX	XXX
Liabilities directly associated with non-current assets classified as held for sale		XXX	XXX
Total liabilities		XXX	XXX

10.6 Risks and uncertainties

Entities can face a number of risks and uncertainties over and above those faced in their routine daily activities. These risks, sometimes referred to as exceptional risks, can include operating or borrowing in foreign currencies—including the risk of foreign currency fluctuations—or dependence on a small number of suppliers or customers. The disclosure by entities of these risks they are exposed to enables users of financial statements to make their own assessments of whether or not they are prepared to continue providing resources to the entity or doing business with it. Although NZ IAS 1 does not specifically require this information to be disclosed, the NZ Framework (paragraph 21) suggests that disclosures about the risks and uncertainties, and resources and obligations not recognised, be disclosed in the notes to the financial statements. What is interesting is that although these disclosures are not required by a New Zealand equivalent to an IFRS, they were required by the predecessor to NZ IAS 1, FRS-9. Here paragraph 8.14, required the disclosure of any information which would enable users of the financial statements to evaluate any exceptional risks the entity is subjected to in its operations.

11 Equity

Under conventional double-entry accounting the equity of an organisation—that is, the shareholders' funds in a company—equals the total assets of the organisation, less its total liabilities. Alternatively, this can be expressed as the total assets of an organisation being matched by the total of the claims held by external parties (liabilities), plus those claims held by the owners.

The NZ Framework, paragraph 49(c), defines equity as the residual interest in the assets of the entity after deducting all its liabilities. The residual interest is a claim or right to the net assets (assets minus liabilities) of the reporting entity. As a residual interest, it ranks after liabilities in terms of claims against the assets of a reporting entity. As is noted in Chapter 1 of *New Zealand Financial Accounting 2e*, the definition of equity is a function of the definitions given to assets and liabilities. Essentially, as the residual interest in the assets of an entity, the recognition criteria for equity are derived from the asset and liability recognition criteria.

The *Companies Act 1993* does not require the residual interest, equity, to be split into its individual components, namely contributed equity and other equity. Other equity usually includes retained earnings, revaluation reserves, and other reserves such as foreign currency translation reserves. However the disclosure requirements of NZ IAS 1 would suggest that the

differing reserves should be separately disclosed. This treatment would be consistent with the current practice of a majority of New Zealand entities whose shares are traded on the New Zealand Stock Exchange.

11.1 Contributed equity

The disclosures relating to contributed equity are detailed in NZ IAS 1, paragraph 68. In this paragraph, an entity is required to disclose:

> *(o) minority interest, presented within equity; and*
> *(p) issued capital and reserves attributable to equity holders of the parent*

These requirements are expanded in paragraph 76(a) which details that information that should be separately and appropriately described. For each class of share capital, the following information should be disclosed either on the face of the statement of financial position or in the notes:

> *(i) the number of shares authorised;*
> *(ii) the number of shares issued and fully paid, and issued but not fully paid;*
> *(iii) par value per share, or that the shares have no par value;*
> *(iv) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;*
> *(v) the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;*
> *(vi) shares in the entity held by the entity or by its subsidiaries or associates; and*
> *(vii) shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts.*

Entities other than companies are not exempt from these requirements. Entities such as partnerships and trusts which generally do not issue shares are required to disclose information equivalent to that required by NZ IAS 76(a) detailed above. This includes disclosing changes in each category, and the rights, preferences and restrictions attaching to each category of equity interest that occurred during the period.

A simple example illustrating the contributed equity portion of an equity disclosure is given in Exhibit 30, while an accepted alternative disclosure appears as Exhibit 30.

Exhibit 30 Disclosure of equity

Note 20 Contributed equity	*2006* *$*	*2005* *$*
Ordinary shares		
Balance at beginning of year	XXX	XXX
Proceeds of share issue	-	XXX
Share issue costs	-	(XXX)
Employee share ownership scheme		
—proceeds from shares issued	XXX	-
Acquisition of subsidiary	XXX	-
Treasury stock	XXX	-
Balance at end of year	XXX	XXX

Exhibit 31 Alternative disclosure of equity with supporting notes

Note 20 Contributed equity	Number of shares	Ordinary shares	Treasury stock	Total
	000s	$	$	$
At 1 April 2004	12 500	4 570 000	-	4 570 000
Proceeds from share issue	500	450 000	-	450 000
Share issue costs				
Balance at 31 March 2005	13 000	5 020 000		5 020 000
Employee share ownership scheme				
—proceeds from shares issued	1800	720 000		720 000
Acquisition of subsidiary	2567	1 180 820		1 180 820
Treasury stock	(1998)	-	(740 000)	(740 000)
Balance at 31 March 2006	15 369	6 920 820	(740 000)	6 180 820

The authorised number of ordinary shares is 20 000 000 (2005: 15 000 000) shares. The shares have no par value. There are no partly paid shares.
During the year the company bought back 1 998 000 shares that were considered surplus to requirements. These shares are held as Treasury stock and the company has the right to reissue these in the future.
Share options are grated to employees with more than five years service. The exercise price of the granted options is equal to the market price of the shares less 20 per cent on the date of the grant.

11.2 Reserves

Entities are likely to have a number of reserves including retained earnings; asset revaluation reserves; foreign currency reserves; hedging reserves and fair value reserves. While the transactions associated with these reserves are covered in more detail in other chapters of *New Zealand Financial Accounting 2e*, their mention here is necessary so that an overview of their disclosure can be provided.

The predecessor to NZ IAS 1, FRS-9 ‘Disclosure of Information in Financial Statements’, was largely silent on the issue of reserves. This meant that guidance on their

disclosure had to be sought from other accounting standards. NZ IAS 1, paragraph 76(b), somewhat improves this position in that it details the overall disclosure requirements for reserves, namely, the nature and purpose of each reserve within equity must be described. Guidance on the detailed disclosure requirements of individual reserves can be obtained from consulting relevant accounting standards. A number of different reserves are considered in the sub-sections that follow.

11.2.1 Retained earnings

Traditionally retained earnings were the accumulated earnings of the entity after dividends paid to shareholders have been deducted. Also disclosed in retained earnings are transfers from other reserves. An example of a transfer of this nature includes the balance remaining on an asset revaluation reserve after the disposal of an item of property plant and equipment (see Chapter 5, *New Zealand Financial Accounting*). Also shown in retained earnings are the cumulative effect of changes in accounting policy and the correction of fundamental errors (IAS 8 49, 34, see Chapter 16).

11.2.2 Asset revaluation reserve

Asset revaluation reserves arise when an item of property, plant and equipment is revalued to fair value after its initial recognition. The revaluation surplus is recognised in equity and therefore does not appear in the income statement (or statement of financial performance). If an item of property, plant and equipment that has been revalued suffers a future decrement in value, this is charged against the asset revaluation reserve. In certain circumstances, a portion of a decrement in value can be charged against retained earnings (NZ IAS 16, paragraphs 3 and 38).

Where the item of property, plant and equipment is scrapped or sold, any balance remaining on the asset revaluation reserve relating to the asset disposed of is transferred to retained earnings as a realised gain. This transfer does not take place through the income statement (NZ IAS 16 paragraph 39). More details of the accounting entries that effect revaluations are provided in Chapter 5 of *New Zealand Financial Accounting 2e*.

11.2.3 Foreign currency translation reserve

A foreign currency translation reserve will occur when a subsidiary of a parent entity is deemed to be a foreign entity. This reserve arises from the translation of the accounts of the foreign entity to the currency of the parent entity and should be recognised in equity (NZ IAS 21 paragraph 30(c)). The translation of the financial statements of foreign entities that give rise to a foreign currency translation reserve, is considered in more detail in Chapter 32 of *New Zealand Financial Accounting 2e*.

11.2.4 Fair value reserve

A fair value reserve results when investments that have been classified as being available-for-sale have been revalued. Any unrealised gain or loss (net of tax) is recognised in equity, rather than in the income statement. When the investment is disposed of, these gains are then included in the income statement.

11.2.5 Hedging reserve

A hedging reserve arises when a financial instrument that has been designated as a cash flow hedge has been revalued. The gain or loss (net of tax) on this revaluation should be deferred and disclosed as a separate component of equity (NZ IAS 39 paragraph 158(a)). These deferred gains and losses are subsequently released to the income statement in the periods in which the hedge item affect the income statement. This issue is considered more completely in Chapter 14 of *New Zealand Financial Accounting 2e*.

From the above discussion it is clear that the movements in all reserves for the period must be disclosed. An example of appropriate reserve disclosure is provided in Exhibit 32.

Exhibit 32 Disclosure of reserves and movements in reserves

	Retained earnings	Asset Revaluation reserve	Fair value reserve	Total
Balance 1 April 2004	XXX	XXX	XXX	XXX
Revaluation	-	XXX	XXX	XXX
Deferred taxation on revaluation		(XXX)	(XXX)	(XXX)
Profit for the year	XXX	-	-	XXX
Distributions to shareholders	(XXX)	-	-	(XXX)
Balance 31 March 2005	XXX	XXX	XXX	XXX
Revaluation	-	XXX	XXX	XXX
Deferred taxation on revaluation	-	(XXX)	(XXX)	(XXX)
Transfer to retained earnings	-	(XXX)	(XXX)	(XXX)
Transfer from asset revaluation reserve	XXX	-	-	(XXX)
Transfer from fair value reserve	XXX	-	-	(XXX)
Profit for the year	XXX	-	-	XXX
Distributions to shareholders	(XXX)	-	-	(XXX)
Balance 31 March 2006	XXX	XXX	XXX	XXX

12 Summary

This book has attempted to provide an overview of the disclosure requirements for general purpose financial statements prepared in accordance with the New Zealand equivalents to International Financial Reporting Standards. It commenced with an overview of financial reporting disclosure in New Zealand and the objectives of general purpose financial reporting. The legislative requirements underpinning financial reporting in New Zealand were examined before the financial reporting framework was reviewed. Finally, the existing financial

disclosure requirements for the statement of financial performance, statement of changes in equity, and statement of financial position, mandated by NZ IAS 1, other accounting standards and the disclosure requirements of the *Companies Act 1993*, were reviewed and illustrated.

End-of-section question

The following trial balance is extracted from the financial records of Dense Toby Limited at 31 March 2006, a company whose shares are listed on the New Zealand Stock Exchange.

	Dr	*Cr*
Accounts payable		256 790
Accounts receivable	434 000	
Advertising expenses	119 260	
Auditors remuneration	16 450	
Bank	74 080	
Buildings – At cost	1 737 000	
Buildings – Accumulated depreciation		138 960
Directors' fees	15 000	
Dividends paid	140 000	
Dividends received		48 420
Expenses—discontinued operation	85 200	
Fixtures and fittings – At cost	45 500	
Fixtures and fittings – Accumulated depreciation		11 375
Interest paid	170 700	
Interest received		17 400
Inventory 1 April 2005	26 450	
Investments	594 660	
Land – at valuation	2 917 500	
Long-term loan		2 244 115
Motor vehicles – At cost	960 000	
Motor vehicles – Accumulated depreciation		384 000
Other expenses	950 720	
Contributed equity		2 150 000
Profit on sale of fixed asset		14 900
Purchases	4 600 590	
Retained earnings at 1 April 2005		1 467 800
Revenue—discontinued operation		144 460
Salaries and wages	2 617 320	
Sales		8 626 210
	15 504 430	15 504 430

The following additional information is available:

- On 1 January 2006, Dense Toby Limited entered into an agreement whereby construction of a new state-of-the-art building which would house the planned factory, would commence during the 2007 financial year. The architect has estimated the cost of the new factory to be $4 410 000. This addition will be financed through a combination of additional equity and borrowings.
- Auditors remuneration comprises the following:

Fee for audit	$9 400
Tax compliance work	$2 300
Design, installation and implementation of 'point-of-sale' software	$4 750
	$16 450

- From discussions with management, it is established that of the figure shown in the trial balance, investments with an original carrying value of $420 100 were held for trading, while the remaining investments were considered available-for-sale. On 31 March 2006, the market value of the available-for-sale shares in listed companies amounted to $220

750 and the trading investment shares in listed companies amounted to $662 260. These market values are considered to be fair value.

- Inventory at 31 March 2006 comprised the following:

Raw materials	$9 460
Work in progress	$14 560
Finished goods	$10 420
	$34 440

- The contributed equity comprises 5 050 000 ordinary shares fully paid.
- On 3 March 2006, A.J. Venter M.I.V.N.Z., an independent valuer, estimated the fair value of the land to be $4 550 000. No entry has been made to take into account this increase in value. The book value of the buildings at balance sheet date was considered to be of fair value. All other items of property, plant and equipment were considered to be held at fair value.
- During the audit, the auditors found that purchases at year end of $11 970 had not been accounted for by Dense Toby Limited.
- A recent down turn in the economy coupled with recent changes in administrative staff, caused the directors to decide that a provision for doubtful debts of 2 per cent of the accounts receivable outstanding at balance sheet date should be made.
- Included in 'other expenses' is depreciation on motor vehicles amounting to $96 000. One third of this depreciation can be allocated to administration expenses. On 1 April 2005, a six-year-old motor vehicle that had originally cost $45 000 and had a carrying value of $18 000 was sold. Depreciation on all other items of property, plant and equipment which is used for administration purposes and which has been correctly calculated, has been provided for on the straight line basis at the following rates:

Buildings	2 per cent per annum
Fixtures and fittings	5 per cent per annum
Motor vehicles	10 per cent per annum

- The long-term loan, which was outstanding for the whole year, is due for repayment on 31 December 2010. Interest is payable at a rate of 8.5 per cent per annum. The loan is secured by way of a mortgage bond over the land and buildings.
- No assets or liabilities from the discontinued operations were considered to be available-for-sale as they were absorbed by the remaining divisions.
- An examination of the ledger account, 'other expenses', shows that they comprise the following:

Accounting fee	$25 800
Bad debts written off	$14 800
Bank overdraft interest	$12 750
Depreciation	$133 015
Distribution expenses	$429 205
Donations	$25 000
Entertainment expenses	$9 540
Fines and penalties	$4 500
Insurance	$35 400
Motor vehicle expenses–administration	$23 220
Motor vehicle expenses–sales representatives	$63 490
Rental–administration building	$58 600
Rental–sales offices	$115 400
	$950 720

- ♦ Included in salaries and wages is an amount of $156 900 paid as a salary to A. Smith, the managing director; and $139 220 paid to B. Jones, the financial director. An amount of $105 000 paid to J. Smith, the marketing manager, while commission of $356 880 was paid to sales staff. All these amounts had been paid in terms of individual employment contracts. The directors' fees were allocated as follows:
  - managing director: $10 000; and
  - financial director: $5000.

  No other employees earned over $100 000 per annum.
- ♦ The Inland Revenue Department will only tax the gains on the financial assets when realised. The provision for bad debts will only be permitted as a deduction when the actual debt is written off. Taxation should be provided for at 30 cents in the dollar. Ignore deferred taxation considerations.

Required

(a) Prepare all the necessary adjustments that can be determined from the above information.

(b) Extract a trial balance and, after making the necessary adjustments, extend the trial balance into the Statement of financial performance, statement of changes in equity and statement of financial position columns.

(c) Using the information in (b) above, prepare a statement of financial performance (allocating the expenses by nature), statement of changes in equity and statement of financial position, together with all the accompanying notes for the financial reporting period ending 31 March 2006. The financial statements should comply with generally accepted accounting practice.

Notes to the 2006 financial statements

1 General information

Dense Toby Limited distributes non-alcoholic beverages aimed at the teenage market. Although its operations have currently been limited to New Zealand, the company plans to expand into the Australian and Asian markets in the next few years.
Dense Toby Limited is a limited liability company incorporated in New Zealand. Its registered office is 33 Hillcrest Road, Hamilton New Zealand.

The company is listed on the New Zealand Stock Exchange.

1.1 Reporting entity

Dense Toby Limited is a company registered under the *Companies Act 1993* and listed on the New Zealand Exchange. The company is an issuer for the purposes of the *Financial Reporting Act 1993*. The financial statements of Dense Toby Limited have been prepared in accordance with the New Zealand *Companies Act 1993* and the *Financial Reporting Act 1993*.

2 Significant accounting policies

The specific accounting policies that materially affect the measurement of financial performance and financial position are set out below. These policies have been applied consistently unless otherwise stated.

2.1 Basis of presentation

The financial statements have been prepared in accordance with generally accepted accounting practice in New Zealand and with International Financial Reporting Standards. The financial statements have been prepared on the historical-cost basis, modified to include the revaluation of land and buildings and available-for-sale financial assets. The presentation currency is New Zealand dollars.

2.2 Property, plant and equipment

Land and buildings comprise retail outlets and administration offices. Land is shown at fair value based on periodic, but at least biannual, valuations by external independent valuers. Other items of property, plant and equipment are shown at historical cost.

Increases in the revaluation of land are credited to the asset revaluation reserve in equity.

Land is not depreciated. Other items of property, plant and equipment are depreciated on the straight line basis.

2.3 Investments

Management classifies investments into two categories. Those financial assets available-for-sale and those held for trading. The classification depends on the purpose the assets were acquired for and is revaluated at each balance sheet date.

Financial assets held for trading

An investment is classified as held for trading if it was acquired primarily for the purpose of selling in the short-term or if management designates them as held for trading.

Available-for-sale financial assets

Available-for-sale financial assets are non-derivatives and are classified as non-current unless management intends to dispose of them in the next twelve months.

Investments are recognised at their fair value at the date of acquisition plus transaction costs. Available-for-sale financial assets and financial assets held for trading are subsequently carried at fair value.

Unrealised gains and losses in available-for-sale financial assets are recognised in equity. Realised and unrealised gains and losses on financial assets held for trading are recognised in the statement of financial performance.

The fair values of equity securities are based on the listed price at balance sheet date. At each balance sheet date management assesses whether any of the financial assets are impaired. Declines in the fair value of an available-for-sale financial asset to below original cost which indicate serious impairment, the cumulative loss, being the difference between the acquisition cost and the current fair value, less any impairment loss previously recognised, is removed from equity and recognised in the statement of financial performance.

2.4 Inventory
Inventories are stated at the lower of cost and net realisable value. Cost is determined using the first-in-first out basis. Net realisable value is the estimated selling price in the ordinary course of business, less costs of completion and less costs incurred in selling expenses.

2.5 Accounts receivable
Accounts receivable are recognised at fair value less provision for impairment.

2.6 Cash and cash equivalents
Cash and cash equivalents include cash on hand, deposits held at call with banks and other short-term highly liquid investments.

2.7 Contributed equity
Contributed equity issued by the company is recorded at the proceeds received less any direct issue costs.

2.8 Borrowings
Borrowings are recognised initially at fair value, net of transaction costs.

2.9 Revenue recognition
Revenue comprises the fair value for the sale of goods. Revenue is recognised as follows:
Sale of goods
Revenue from the sale of goods is recognised when the goods are delivered and title passes.
Interest income
Interest income is recognised in a time-proportion basis using the effective-interest method.
Dividend income
Dividend income is recognised when the company's right to receive payment is established.

2.10 Distributions
Distributions to shareholders are recognised as liabilities in the period in which they are approved by the company's shareholders.

3 Critical accounting estimates and judgments
Estimates and judgments are continually evaluated based on historical experiences and other factors. These include the expected outcomes of future events.

3.1 Critical accounting estimates and assumptions
A number of estimates and assumptions concerning the future are made by the company. For this reason, accounting estimates seldom equal the actual result. The estimates and assumptions that may cause material adjustment to the carrying amount of assets and liabilities within the next financial year are as follows:

Taxation
Significant judgement is required in determining the provision for income tax as there are a number of transactions which are awaiting clarification for the Inland Revenue Department. If the outcome of these matters is different from the amounts that were recorded in the financial statements, this will impact upon the provision for income tax in the period these items are finalised.

	$
4 Revenue	
Sales	8 626 210
5 Other income and gains	
Gain on asset held for trading	242 160
Dividends received	48 420
Interest income	17 400
Investment income	307 980
Profit on sale of property, plant and equipment	14 900
	322 880
6 Operating profit	
Within operating profit, expenses are classified by nature as follows:	
Advertising	119 260
Auditor's remuneration	
Audit services	
− Fee for audit	9 400
Taxation services	
− Tax compliance work	2 300
Other services	
− Design, installation and implementation of software	4 750
	16 450
Bad debts	23 480
Changes in inventories of finished goods and work in progress	(7 990)
Depreciation of property, plant and equipment	133 015
Donations	25 000
Employment benefit expenses	2 632 320
Other expenses	75 240
Raw material and consumables used	4 612 560
Rental expenses	174 000
Transport expenses	515 915
Total cost of goods sold, administration and marketing and distributions expenses	8 319 250
7 Finance costs	
Interest paid	203 500
8 Taxation	
Normal tax	44 940
Deferred taxation	-
	44 940

The tax charge for the year can be reconciled to the profit shown in the statement of financial performance as follows:	$
Profit before tax	426 340
Tax on profit at 30 per cent	127 902
Income not subject to taxation	(87 174)

Expenses not deductible for tax purposes	6 816
	47 544

9 Discontinued operations

Revenue from discontinued operations	144 460
Expenses from discontinued operations	85 200
Profit before tax on discontinued operations	59 260
Taxation	17 778
Profit for the year from discontinued operations	41 482

10 Property, plant and equipment

	Land	Buildings	Fixtures and fittings	Vehicles	Total
Cost or valuation	2 917 500	1 737 000	45 500	1 005 000	5 705 000
Accumulated depreciation	-	69 480	6 825	187 000	263 805
Net book value	2 917 500	1 667 520	38 675	817 500	5 441 195
Year ending 31 March 2005					
Opening net book value	2 917 500	1 667 520	38 675	817 500	5 441 195
Depreciation expense	-	34 740	2 275	100 500	137 515
Net book value	2 917 500	1 632 780	36 400	717 000	5 303 680
At 31 March 2005					
Cost or valuation	2 917 500	1 737 000	45 500	1 005 000	5 705 000
Accumulated depreciation	-	104 220	9 100	288 000	401 320
Net book value	2 917 500	1 632 780	36 400	717 000	5 303 680
Year ending 31 March 2006					
Opening net book value	2 917 500	1 632 780	36 400	717 000	5 303 680
Revaluation surplus	1 632 500	-	-	-	1 632 500
Disposals	-	-	-	45 000	45 000
Depreciation expense	-	34 740	2 275	96 000	133 015
Net book value	4 550 000	1 598 040	34 125	576 000	6 758 165
At 31 March 2006					
Cost or valuation	4 550 000	1 737 000	45 500	960 000	7 292 500
Accumulated depreciation	-	138 960	11 375	384 000	534 335
Net book value	4 550 000	1 598 040	34 125	576 000	6 758 165

The land was revalued on 3 March 2006 by A.J. Venter M.I.V.N.Z, an independent valuer, to fair market value. The surplus on revaluation has been credited to the asset revaluation reserve in equity.

Depreciation expenses of $69 015 (2004 - $XXX) has been charged to administration expenses and $64 000 (2005 - $XXX) to Marketing and distribution expenses.

If land was stated at historical cost the amount would be $2 917 500 (2004 - $2 917 500).

Land and buildings are mortgaged to the value of $2 244 115 (2004 - $2 244 115).

Depreciation is calculated on the straight-line basis at the following rates:

Buildings	2 per cent per annum
Fixtures and fittings	5 per cent per annum
Motor vehicles	10 per cent per annum

	$
11 Available-for-sale financial assets	
Balance at beginning of year	174 560
Revaluation surplus transferred to equity	46 190
Balance at end of year	220 750

Available-for-sale financial assets comprised New Zealand equity securities

12 Inventories	
Raw materials	9 460
Work in progress	14 560
Finished goods	10 420
	34 440

13 Accounts receivable	
Accounts receivable	434 000
Less: Provision for doubtful debts	8 680
	425 320
Fair value of accounts receivable	425 320

The fair value is based on cash flows discounted using a rate based on the borrowing rate of 8.5 per cent.

14 Financial assets held for trading	
New Zealand equity securities	662 260

Changes in the fair values of financial assets held for trading are recorded in Other income and gains in the statement of financial performance (Note 5).

15 Long-term liabilities	
The long-term loan of $2 244 115 is due for repayment on 31 December 2010. Interest is charged at a rate of 8.5 per cent per annum[1]. The loan is secured by way of a mortgage bond over the company's land and buildings described in Note 10.	2 244 115

16 Trade and other payables	
Trade payables	268 760
Accrued expenses	20 050
	288 810

17 Equity	
Contributed equity	
Comprises 5 050 000 ordinary shares fully paid	2 150 000

[1] As no principal is due to be paid in the next twelve months, and the amount will be repaid in full at the end of the loan period, no principle portion is disclosed as a current liability.

There were no movements in contributed capital for the year. The company has only one class of share.

The authorised number of ordinary shares is 10 000 000 (2005: 10 000 000).

Reserves

	Retained earnings	Asset revaluation reserve	Fair value reserve	Total $
Balance 1 April 2005	1 467 800	-	-	1 467 800
Revaluation during the current year	-	1 632 500	46 190	1 678 690
Earnings for the year	422 882			422 882
Distributions	(140 000)			(140 000)
Balance at 31 March 2006	1 750 682	1 632 500	46 190	3 429 372

18 Distributions

Dividends on ordinary shares	140 000

19 Directors' remuneration

Directors of the company during the year and their remuneration and other benefits paid were as follows:

A. Smith	
Salary and other short-term benefits	166 900
B. Jones	
Salary and other short-tem benefits	144 220
Total director's remuneration	311 120

20 Employees' remuneration

Remuneration and other benefits of $100 000 per annum or more received by employees in their capacity as employees

	No of employees
$100 000–$110 000	1
$140 000–$150 000	1
$150 000–$160 000	1

21 Capital commitments

The company has entered into an agreement to construct a new factory during 2007. The estimated cost is $4 410 000. This will be financed through a combination of additional equity and borrowings.

Review questions

1 What reasons did Lont (1997) provide for the possible low level of financial statement disclosure that used to exist in New Zealand?

2 List the arguments that management could use to justify the non-disclosure of certain financial information. Do these arguments have any merit?

3 What are the objectives of general purpose financial reporting?

4 What legislation underpins financial reporting in New Zealand?

5 Section 2 of the *Financial Reporting Act 1993* defines an entity as a company or any issuer. What does 'issuer' include?

6 List the documents that would be found in a set of financial statements.

7 Why are supporting notes considered integral to the financial reporting process?

8 Explain the relationship between accounting concepts, specific principles, bases, conventions, rules and practices, and accounting policies.

9 Explain how the specific principles, bases, conventions, rules and practices can be used to explain the NZ IAS 16 'Property, Plant and Equipment' requirement to disclose depreciation expenses.

10 What information should be provided by an entity when it prepares its statement of accounting policies?

11 What, if any, are the major differences between an income statement prepared for internal reporting purposes and a statement of financial performance prepared for external reporting purposes?

12 When deciding what information should be disclosed in financial statements, what factors should preparers consider?

13 Provide an example of when offsetting in financial statements is permitted and when it is not permitted.

14 What six accounting policies are discussed in details in NZ IAS 1 in connection with the fair presentation of financial statements.

15 What circumstances would lead to an individual item of revenue requiring separate disclosure?

16 What expense items does NZ IAS 1 'Presentation of Financial Statements' require to be separately disclosed?

17 Provide two examples of how the accruals basis of accounting might work.

18 What circumstances would lead to an individual item of operating expense requiring separate disclosure?

19 The following items were extracted from the financial records of Grand Limited at 30 June 2006. Bad debts written off during the year amounted to $23 567. In addition, owing to the improved business environment, the directors decided to reduce the provision for doubtful debts by $55 000. How would this information be disclosed in the financial statements?

20 How would profit before taxation shown in the statement of financial performance be calculated?

21 During the year ended 31 March 2006, the directors of Opening Limited decided to close down its door manufacturing division. Explain to them why it is important for the profit or loss from continuing activities to be disclosed separately from discontinued activities?

22 Who or what is a director? Provide examples.

23 What items are included in the directors' remuneration?

24 Is there any difference between the terms 'directors' fees' and 'directors' remuneration'. Explain.

25 In relation to directors' remuneration, what information should be disclosed?

26 Mr Zimmer was appointed director of Industrial Safety Limited on 1 April 2003. Included in his employment contract are the terms of his remuneration.
These included:

- ♦ a monthly salary of $6000
- ♦ a Christmas bonus equal to one month's salary
- ♦ subscriptions to the Body Shop Health Club at $2400 per annum
- ♦ a commission of 0.02 per cent of net sales (net sales for the year ended 31 March 2006 amounted to $45 700 000).

Required

Calculate the director's remuneration that will be disclosed in the financial statements for the year ended 31 March 2006.

27 How does a statement of changes in equity contribute to attaining the objectives of general purpose financial reporting?

28 What items require separate disclosure in a statement of changes in equity?

29 Does a statement of financial position reflect the value of an entity? What information does it provide?

30 Where an entity has provided a loan to a director, what information should be disclosed?

31 If an entity owns items of property, plant and equipment, should the rates at which it depreciates these assets be disclosed in the accounting policy note? Explain.

32 How is goodwill calculated?

33 How would internally generated goodwill be disclosed in financial statements?

34 If an entity has a listed investment, what additional information should be disclosed in relation to this asset?

35 Where an entity has borrowings, what additional information should be disclosed?

36 Why is the disclosure of amounts committed for future capital expenditure but not yet recognised as a liability important?

37 What is an exceptional risk? Provide two examples.

Review problems

38 An inexperienced accountant prepared the attached statement of financial position at 31 August 2006. You have been employed to redraft it so as to comply with the express requirements of the *Companies Act 1993* and all applicable financial reporting standards. Comparative figures should be ignored.

The following additional information is available:

- The mortgage principal repayments are $11 000 per annum. The interest rate is 6 per cent. The mortgage loan is secured over the land.
- $5000 was credited to the asset revaluation reserve during the year for a land revaluation.
- Income tax of $4600 was payable to the Inland Revenue Department.
- Investments comprise a 14 per cent stake (16 000 shares) in Sharky Limited, which cost $32 000. The remainder of the investment is in 4 per cent Government bonds. The market value of the shares is currently $18 000 and of the bonds $60 000. Both investments are available-for-sale.
- Plant and machinery, which was purchased on 1 March 2006, is depreciated on the straight-line basis over the estimated useful life of ten years. There is no expected residual value.
- Of the inventory $2200 was work in progress and $3800 finished goods.
- The debentures are secured by a floating charge over the company's assets.
-

Accent Limited
Statement of financial position at 31 August 2006

	$		$
Share capital and reserves		Fixed assets	
Issued capital—25 000 shares	90 000	Plant and machinery	38 000
Land revaluation	5 000	Land	95 345
Profit and loss account	19 345	Long-term liabilities	
Investments	85 000		
Debentures 15%, due 2008	10 000		
Mortgage	55 000		
Current liabilities		Current assets	
Bank overdraft	15 900	Inventory	6 000
Tax payable	4 600	Cash at bank	1 300
Trade creditors	3 800	Trade debtors	600
	203 645		226 245

39 The following balances have been extracted from the trial balance of EBH Limited for the year ended 31 March 2006.

	Statement of financial performance	Statement of changes equity	Statement of financial position
(a) EBH Limited had sales of $474 434 for the year.			
(b) At balance date, accounts payable amounted to $13510.			
(c) Accounts receivable had a balance of $35 043 at balance date.			

(d)	50 000 shares were issued with a contributed equity amount of $105 000.			
(e)	Cost of sales amounted to $210 312.			
(f)	At 31 March 2004, EBH Limited's brand was valued at $44 000.			
(g)	Administration expenses for the year amounted to $33 353.			
(h)	Inventory was valued at $65 780 with $10 990 being work in progress and $45 105 raw materials. The balance comprises consumable stores.			
(i)	On 14 June 2003, a donation of $10 000 was made to Greenpeace.			
(j)	Investments at 31 March 2004 amounted to $60 000.			
(k)	The auditors were paid an amount of $1 000 for audit services.			
(l)	Royalties amounting to $185 000 were received by EBH Limited for the use of its intellectual property.			
(m)	Property, plant and equipment had a carrying value of $74 987 at balance date.			
(n)	EBH Limited recently acquired a small business to obtain a brand. Included in the sale price was goodwill amounting to $25 000.			
(o)	The principal repayment on the long-term loan due for payment in the 2005 financial year amounts to $14 200.			
(p)	$52 800 is currently owed on a long-term loan. This loan is secured by way of a floating charge over the company's property, plant and equipment.			
(q)	Deferred taxation amounted to $23 600 (Cr).			
(r)	The taxation expense for the year amounted to $19 100.			
(s)	The balance on the Inland Revenue Account in the general ledger at balance date amounted to $4 775 (Cr).			
(t)	Employee entitlements at balance date amounted to $13 800.			
(u)	The two directors shared a total salary of $280 000 for the year equally.			
(v)	EBH Limited owes $37 340 that is due in the next three months.			
(w)	At 31 March 2004, the balance on the asset revaluation reserve amounted to $34 560. No revaluations occurred during the year.			
(x)	At balance date the bank balance was $14 325 (Cr).			
(y)	Distributions to shareholders during the year amounted to $30 000.			
(z)	Retained earnings at 1 April 2003 amounted to $23 660 (Dr).			
(aa)	Interest revenue of $18 011 was earned during the year.			
(bb)	Depreciation amounted to $18 000 for the year.			

(cc) Debtors amounting to $15 120 were written off during the year.			
(dd) Brand amortisation amounted to $5400.			
(ee) Goodwill amortisation amounted to $3600.			
(ff) Owing to unfavourable publicity, at balance date the directors decided that the brands had been impaired by $23 000.			

Required

(a) Allocate the above transactions to the appropriate statement of financial performance by nature, statement of financial position and statement of changes in equity columns.

(b) Prepare the statement of financial performance, statement of financial position and statement of changes in equity, together with supporting notes, for the year ended 31 March 2006. These financial statements must comply with the requirements of the *Companies Act 1993* and appropriate financial reporting standards. Only information that can be reasonably determined from the above information should be disclosed.

40 Major Limited commenced operations on 15 September 2005. The following trial balance has been extracted from the financial records at 31 December 2006.

The following additional information is available:

- ♦ The mortgage principal is repayable in equal instalments of $21 290 per annum. Interest is charged at a rate of 7 per cent per annum. The mortgage is secured over the company's land.
- ♦ During the year, the land was revalued.
- ♦ Inventory on hand at the beginning of the period amounted to $34 000.
- ♦ The debentures are due for repayment in 2009. Interest is payable at 5 per cent per annum.
- ♦ Director's fees and remuneration is split 50/50 between the two directors. The wife of one of the directors has an account with Firefly Limited with a balance of $3000 due for payment on 29 January 2007.
- ♦ The trading investment of 56 000 shares in Firefly Limited, a listed company, equals a 20 per cent holding, has a market value of $26 000 at balance date. This decline in value is not considered to be permanent. Major Limited is unable to exert any significant influence over Firefly Limited.
- ♦ The government stock is available-for-sale and has held its value.
- ♦ All non-current assets were acquired during the current year. The depreciation on the building was overlooked when the depreciation was calculated. The building (which was acquired on 1 April 2006) should be depreciated on a straight-line basis over twenty-five years. There is no residual value.

- The tax rate is 30 per cent.

	Dr $	Cr $
Accounts receivable	37 500	
Accounts payable		85 500
Asset revaluation reserve (land)		13 800
Bank overdraft		13 000
Buildings	260 000	
Cash at bank	56 300	
Contributed equity (250 000 shares fully paid)		200 000
Debentures		30 000
Inventory—finished goods	22 000	
Investment in 6 per cent Government stock	15 000	
Investment in Firefly	88 000	
Land	335 000	
Mortgage bond		319 350
Plant and machinery	86 400	
Retained earnings 1 January 2006		39 800
Tax payable		18 900
Work in progress	6 200	
Other expenses	23 600	
Audit fees	15 000	
Cost of sales	498 160	
Depreciation	9 600	
Directors' fees	30 000	
Directors' remuneration	204 000	
Dividends received		1 000
Interest paid	23 840	
Interest received		200
Sales		989 050
	1 710 600	1 710 600

Required
Prepare the statement of financial performance by function, statement of financial position and statement of recognised revenues and expenses, together with supporting notes, for the year ended 31 December 2006. Only information that can reasonably be determined from the above information should be disclosed. The financial statement must comply with the express requirements of the *Companies Act 1993* and generally accepted accounting practice. Accounting policy notes are not required.

41 The following information has been extracted from the financial records of Gemstone Limited at 31 December 2006.

	Dr $	Cr $
Accounts payable		30 625
Accounts receivable	50 005	
Advisory services	77 375	
Audit fee	28 500	
Bad debts	1 450	
Bank overdraft		27 500
Buildings	285 000	

Cash at bank	4 534	
Cost of sales	375 440	
Directors' fees	6 000	
Dividends paid	10 200	
Interest received		1 800
Interest paid	7 875	
Inventory	65 000	
Land	404 560	
Mortgage loan		175 000
Other expenses	22 350	
Contributed equity		516 000
Plant and machinery	167 500	
Retained earnings		123 464
Sales		945 050
Shares in listed company at cost	185 000	
Staff wages	128 650	
	1 819 439	1 819 439

The following additional information is available:

- The mortgage on the buildings is fixed at 6 per cent per annum. The mortgage will be fully repaid in equal instalments over five years. The loan is secured over the buildings.
- Gemstone Limited has three months' interest outstanding on the mortgage loan.
- The buildings, which are depreciated over fifteen years, have an estimated $15 000 residual value. Plant and machinery, which is depreciated over five years, has a $500 residual value. The buildings and the plant were acquired on 1 January 2006. After consideration, the directors decide that at balance date, the plant and machinery has been impaired by $1500.
- The shares are in listed dot.com companies whose value has plummeted to $5000.
- Accounts receivable have a fair value of $45 000, with $2500 being owed by a related party.
- Contributed equity comprises 325 000 ordinary shares.
- Raw goods comprise 15 per cent of inventory, work in progress 30 per cent of inventory, while the balance comprises finished goods. Inventory at the beginning of the year amounted to $84 000.
- On 30 December 2006 Gemstone Limited entered into a contract to purchase a new gem-cutter at a cost of $325 000.
- On 24 December 2006 the land was revalued by Conston Limited, a firm of independent valuers, to $415 000, the fair value of the land.
- Taxation is paid at a rate of 30 cents in the dollar.

Required

Prepare the statement of financial performance by nature, statement of financial position, statement of recognised income and expenses together with all accompanying notes for the year ending 31 December 2006. Only information that can reasonably be determined from the above information should be disclosed. The financial statement must comply with the express requirements of the *Companies Act 1993* and generally accepted accounting practice. Accounting policy notes are not required.

42 The following information has been extracted from the records of Hianca Limited at 31 March 2006.

	Dr $	Cr $
Accounts payable		23 400
Accounts receivable	50 060	
Bank overdraft		40 000
Buildings	359 660	
Cash at bank	24 280	
Contributed equity		250 000
Cost of sales	1 675 000	
Directors' fees	166 000	
Dividend income		5 000
Dividends paid	2 500	
Interest paid	6000	
Interest received		6700
Inventory	48 000	
Land	335 000	
Mortgage bond		150 000
Other expenses	226 000	
Plant and machinery—at cost	125 150	
Plant and machinery—accumulated depreciation		38 750
Retained earnings—1 April 2005		439 800
Shares in listed company at cost	200 000	
Sales		2 450 000
Staff wages	186 000	
	3 403 650	3 403 650

The following additional information is available:

- Included in Other expenses is an amount of $24 000 in audit fees and $8000 in donations. Thirty per cent of the remaining expenses must be allocated to administration expenses and fifteen per cent to distribution costs. Forty per cent of the staff wages expense must be allocated to administration expenses.
- The mortgage, which is secured over the buildings, is fixed at 8 per cent per annum. An amount of $50 000 representing the principal component is due for repayment during the next financial year.
- Six months' worth of interest payments must be accrued.
- The buildings, which are being depreciated on a straight-line basis over twenty-five years, have a zero residual value. Plant and machinery, which has a zero residual value, is depreciated on a reducing-balance basis at 20 per cent per annum. Hianca Limited acquired the buildings on 1 January 2006. No depreciation has been accounted for to date.
- The market value of the 100 000 shares in the listed company is currently $212 000. The investment is available-for-sale.
- Contributed equity comprises 550 000 ordinary shares.
- Thirty-five per cent of the inventory is work in progress, the balance is finished goods. Inventory at the beginning of the year amounted to $34 000.
- On 15 March 2006, Hianca Limited entered into a contract to construct a new factory costing $460 000. Construction will commence on 24 November 2006.

- Ace Valuers revalued the land on 30 March 2006 at $650 000, using fair value. No entry has been made to take into account this revaluation.
- The taxation rate is 30 per cent.

Required

Prepare the statement of financial performance by function, statement of financial position and statement of changes in equity, together with supporting notes, for the year ended 31 March 2006. Only information that can reasonably be determined from the above information should be disclosed. The financial statement must comply with the express requirements of the *Companies Act 1993* and generally accepted accounting practice. Accounting policy notes are not required.

43 Read the article in Financial Accounting in the News 1 by Fiona Rotherham, which appeared in the 22 January 2000 issue of *The New Zealand Herald*, entitled 'Taking stock of business'. This article examines the use of share options to reward directors. The question is should these options form part of directors' remuneration and, if so, how should they be disclosed?

Financial Accounting in the News

The New Zealand Herald

22 January 2000

'Taking stock of business' by Fiona Rotherham

Gone are the days when bosses just get paid cash for what they do. The trend among New Zealand's top listed companies is to include executive stock options as part of the overall remuneration package. Americans call it 'having skin in the game'.

The theory behind share options is that giving senior management part-ownership of the company aligns their interests with those of shareholders. Options grant executives the right to buy some of a company's equity at an agreed price at a specified future date. The benefits of options is they focus management attention on shareholder value and help drive down costs. They also cut the cash cost of attracting top employees by promising future wealth.

The trouble with them, as burnt 1980s investors will recall, is there is every reason in a bull market for the executive to hype up the share price on unproven and optimistic forecasts. Outside investors buying in at inflated prices carry the risk, while executives holding the options risk little and gain much.

In the United States options, combined with a buoyant stock market, have made millionaires of many managers. According to *The Economist* the top employees of big American firms now have a claim on more than 13 per cent of their firms' equity.

The latest New Zealand stock option schemes have mainly been performance-based. There are hurdles the executives have to lift the company over before they gain the options. One of the most common hurdles is measuring the company's share price against the NZSE40 index. Options are granted only if the company's performance beats the index. Another common hurdle is an increase of, say, 25 per cent in the share price over three years. Under stock exchange rules, listed companies are required to obtain shareholder approval before introducing stock options, provided more than 2 per cent of the issued capital is involved or if directors are recipients.

Last November opposition by small shareholders to Auckland International Airport's new share options scheme failed to ground it. The options' exercise price was the market price of the airport's shares at the time of issue, pegged to movements in the NZSE40 index and adjusted for dividends paid. The options would be exercisable only three years after the issue date, lapsing

after six years. Under the scheme, chief executive John Goulter gets up to 250,000 shares a year for the next four years.

Airport general manager corporate Chris Curley says shareholder opposition was based on a misunderstanding of how the scheme worked. 'Whenever the word options is mentioned shareholders throw up their hands in horror and ask "what are you giving away?"'. The airport's 'plain vanilla' scheme was chosen to make it acceptable to institutional investors and other shareholders.

Barry Lindsay, chief investment officer for AXA NZ, says he has no qualms about the airport options. 'Our own company has an options scheme similar to it. I can appreciate the attributes of it'. A market surveillance panel member, Mr Lindsay reckons the listing rules provide sufficient shareholder protection from any 'outrageous' schemes.

Options impose a cost on shareholders by diluting a firm's existing equity. This transfer of wealth worsens if the strike price—the price executives pay for the options—is much below the current market price. The executive gains the value without doing anything. 'There has been bad press in the US recently about companies not properly counting the cost of stock options.

Microsoft is one with huge problems', says group human relations director Bob Barbour. Even without stock options Lion Nathan's chief executive Gordon Cairns is New Zealand's top paid executive, on $2.29 million—and that's after a half million dollar pay cut last year.

Lion Nathan has adopted an executive performance share scheme starting to gain credence among top British companies in preference to stock options. The company buys back existing shares to hand out to staff rather than creating new shares. These are earned by executives over a three-year period derived from a percentage of their base pay and performance bonuses. If they don't make their bonuses, less goes into the pot for their free shares. The shares are not taxed, unlike the capital gain on options.

The Australian Shareholders Association—there is no NZ equivalent as yet—this week voiced concern about the number of share plans and fee increases granted to Australian company executives, regardless of performance. Spokesman Stan Mather says options are becoming an add-on to executive salaries that in many cases is 'taken for granted and not earned'. It is not the idea of stock options he objects to. It is whether the company performance has to have improved and how those hurdles are measured.

The Investment and Financial Services Association (representing Australian institutional shareholders) introduced stock option policy guidelines a few years ago, saying its members would view favourably companies that followed them. These are currently under review.

Association chief executive Lynn Ralph says there has been investor concern that past performance hurdles had not been sufficiently rigorous. The equivalent NZ group—the Investment Savings and Insurance Association—plays no similar watchdog role. It is left up to individual shareholders to examine the options schemes presented to them and vote accordingly when given the chance.

Remuneration consultant Edward Wright helped structure the Brierley Investments options scheme passed by shareholders in November. Following on from 15 million options issued to BIL chairman Sir Selwyn Cushing, a further 54.5 million options were to be made available to senior executive staff who are not directors. Unlike the options granted to Sir Selwyn, the management ones have hurdles. Split into three branches, the exercise prices are 65c, 75c and 90c. The Brierley price must exceed 75c, 130c and 150c respectively over a 30-day period before the executives can gain them. If not designed appropriately, option schemes are a 'free gift', Mr Wright says. They also need to be company specific. 'The BIL plan was designed for a specific situation. In the case of a company, say in the construction industry where it is typically cyclical, the relevant performance is comparing it to the basket of shares within that industry.'

The pioneers of stock options were the knowledge-based start-up companies backed by venture capital. With the 'dot.com' boom, potential employees in hot demand look to those companies with an attractive stock options package, or they go elsewhere. It means a firm with no bottom-line profit and little else can compete for staff head-to-head with the likes of IBM, simply by enticing top people through options. Silicon Valley is built on options for most staff, not just the bosses.

Accounting rules mean companies do not have to treat options as an expense, charged against reported profits, as they do with other forms of compensation. Thus options prove a cheap way to pay top staff. In New Zealand, IT Capital last week gained shareholder approval to release up to 5 per cent of total shares for management options. Last August managing director Keith Phillips was granted 1.7 million options at 17c, the then market price. IT Capital's share price is trading around 78c.

Shareholders questioned, but approved, Mr Phillips' ability to cash in the options at will. Mr Phillips says the norm in US venture capital companies is to have 15 per cent of the firm's capital held in staff stock options. 'Because it can lead to substantial fortunes, it is what attracts

talented people from their blue-chip, low-risk environment. This, in turn, has fuelled the success of technology and could even have contributed to the substantial economic growth in the US.'

Shareholders showed no opposition at last year's AGM of share market darling Advantage to the proposed issue of 27.5 million options—15 per cent of the company's capital—to directors and staff. Yet the exercise price was below the market price.

KMPG Consulting, as part of its globalisation programme, is floating a new worldwide consulting company on the New York Stock Exchange mid-year. In a bid to attract and retain key staff, the new company will issue 10-year options with a four-year vesting period to all existing staff, provided they have met performance criteria already in place. Up to 20 per cent of the US company's equity will be distributed in options. Some will be handed out immediately. Others linked to future performance come into force later.

Spare a thought for Cleveland shipping company executive John Lauer. *Fortune* magazine reports Mr Lauer eschewed a salary, working solely for an options package that could earn him 8 per cent of the booming company's capital next year. Even then, the option price is linked to the company's long-term growth.

Challenging questions

44 The following information has been extracted from the financial records of Massy Tractors Limited for the year ended 31 March 2006.

	Dr *$*	*Cr* *$*
Accounts receivable	148 900	
Accounts payable		88 987
Auditors' remuneration—fees	3 650	
Bank charges	1 099	
Bank interest paid	2 675	
Cash	178 105	
Contributed equity		500 000
Cost of sales	978 989	
Depreciation	–	
Directors' remuneration	165 600	
Dividends paid—interim	100 000	
Dividends received		4 410

Inland Revenue Department	43 500	
Insurance paid	2 912	
Inventory (merchandise) 31 March 2006	124 312	
Investment in Farmers Supply Limited	68 600	
Land	610 000	
Long-term loan		267 900
Motor vehicles (book value)	95 000	
Other miscellaneous expenses	56 898	
Patent (book value)	55 000	
Plant and equipment (book value)	104 000	
Provision for doubtful debts		3 567
Retained earnings		345 908
Salaries and wages	234 950	
Sales—retail		1 767 903
Sales returns	1 556	
Telephone	2 929	
	2 978 675	2 978 675

The following additional information is available:

At 31 March 2005, contributed equity comprised 4 000 000 shares fully paid up and totalling $800 000 in value. On 3 September 2005, the directors resolved to buy back 1000 000 shares at $0.30 each. The buy-back took place on 1 November 2005. The only entry made in respect of this transaction was:

Dr		Contributed equity	300 000	
	Cr	Bank		300 000

- Depreciation is provided for at the following rates on book values:
  - Motor vehicles—20 per cent per annum.
  - Plant and equipment—15 per cent per annum.
- The patent is amortised at 10 per cent per annum on book value. This reflects fair value.
- The long-term loan of $267 900 due for repayment in full on 31 December 2010 is secured by a floating charge over the company's assets. The interest rate is fixed at 8.0 per cent per annum. Interest for the year has not yet been provided for.
- On 1 January 2006, Massy Tractors Limited entered into an agreement with Billy Construction Limited to construct an administration and workshop complex on its land. The contracted value of this undertaking is $302 000. Construction, which is expected to commence on 1 August 2006, will be financed by additional borrowings.
- The trading investment in Farmers Supply Limited consists of 24 500 ordinary shares acquired at $2.80 per share. At 31 March 2006, Farmers Supply Limited shares were trading on the New Zealand Exchange at $3.45 per share.
- In order to 'strengthen the balance sheet' the directors decided to have the company's land revalued. D.J. Williams MIV, who undertook the valuation on 1 March 2006 using the fair-value basis, valued the land at $650 000. No adjustments have been made to take this revaluation into account.

- On 6 May 2006, before the financial statements were finalised, a debtor who owed the company $12 600 was declared insolvent. Initial indications are that no liquidation dividend will be received.
- Massy Tractors Limited maintains a provision for doubtful debts of 2 per cent of year-end accounts receivable.
- The company has only two directors, Mr D.T. James and Ms U.R. Shank. Mr James received remuneration of $112 300 for the year, while Ms Shank, who was appointed on 31 August 2005, received $53 300. Prior to her appointment as director, Ms Shank earned a salary of $38 600 from Massy Tractors Limited in her capacity as the bookkeeper. Mr James' son owes Massey tractors $2500 at balance sheet date. No other directors have ever been appointed.
- Inventory held at 1 April 2005 amounted to $120 555.
- At balance sheet date accounts receivable had a fair value of $145 000.
- On 3 May 2006, a fire in the company's workshop destroyed specialised plant and machinery with a book value of $70 000. As a result of this fire, Massy Tractors Limited is uncertain whether it will be able to comply with certain contractual obligations. If the company defaults on these obligations it is likely to incur a financial penalty of $500 000, which will place a significant strain on the company's financial resources.
- After balance date, the directors decided that a final dividend of $0.02 per ordinary share in issue at year end would be paid sometime in May 2006. This decision has been communicated to shareholders.
- Taxation of $74 732 must still be provided for. Ignore deferred taxation considerations.

Required

Prepare the financial statements of Massy Tractors Limited for the year ended 31 March 2006 from the information provided. These financial statements should comprise:

- a statement of financial performance by nature
- a statement of financial position
- a statement of changes in equity
- the accompanying notes.

Prepare the financial statements so as to comply with the express requirements of the *Companies Act 1993* and generally accepted accounting practice. Accounting policy notes are not required.

45 The following balances have been extracted from the financial records of Wilt Extra Limited at 31 March 2006.

	Dr *$*	*Cr* *$*
Accounting fees	15 789	
Auditors' remuneration	4 652	
Bank charges	976	
Dividend paid (interim on ordinary shares)	71 250	
Electricity and water	1 095	
Entertainment	2 933	
Fees paid	5 095	
Interest paid	26 078	
Legal expenses	684	

Other miscellaneous expenses	45 657	
Purchases	1 045 912	
Rent	12 984	
Salaries and wages	503 892	
Sales		1 905 932
Sales returns	2 675	
Subscriptions	3 546	
Teas and cleaning	997	
Accounts payable		38 312
Accounts receivable	43 865	
Bank	768 225	
Inland Revenue Department	127 848	
Inventory—1 April 2005	186 902	
Loan		356 500
Non-current assets—Note 4	3 606 945	
Contributed equity—ordinary shares		2 658 000
Contributed equity—preference shares		1 000 000
Provision for deferred tax		39 434
Retained earnings 1 April 2005		479 822
	6 478 000	6 478 000

The following additional information is available:

- Inventory at 31 March 2006 amounted to $254 342.
- Included in the amount of $26 078 of interest paid is bank overdraft interest of $2945. The loan of $356 500, which is secured over the company's land, attracts interest at 8 per cent per annum and is repayable in full on 31 December 2007.
- Equity comprises 2 000 000 6 per cent preference shares fully paid. No dividends have been declared in respect of these shares for the current year.

  On 1 April 2005, ordinary share capital comprised 4 750 000 shares fully paid. On 3 July 2005, an additional 1 500 000 shares were issued at $0.50 each. The issue was fully subscribed. On 2 February 2006 Wilt Extra Limited bought back 570 000 of the issued ordinary shares at $0.60 per share to be held as treasury stock. The only entry made in respect of this transaction was:

Dr		Contributed equity—ordinary shares	342 000	
	Cr	Bank		342 000

- Non-current assets comprise the following:

Land and buildings

Situated at 34 Avenue Road East, Hastings, and costing $1 590 000. On 19 January 2006, the company's land was revalued. B.P. Brooke MIV, who undertook the valuation on that date using the fair-value basis, valued the land and buildings at $1 754 000. Buildings are not depreciated.

	$
Plant and machinery	
At cost	1 965 000
Accumulated depreciation	420 000
Book value 1 April 2005	1 545 000

Depreciation is provided on the diminishing balance basis at 15 per cent per annum.

	$
Motor vehicles	
At cost	365 000
Accumulated depreciation	131 800
Book value at 1 April 2005	233 200

Motor vehicles are depreciated on the straight-line basis at 20 per cent per annum.
A motor vehicle originally acquired on 1 August 2003 for $36 900 was sold by Wilt Extra Limited on 1 July 2005 for $24 855. The only entry made in the financial records in respect of this transaction was:

Dr		Bank	24 855	
	Cr	Motor vehicles		24 855

There have been no other transactions relating to fixed assets.

- ♦ On 2 May 2006, before the financial statements were finalised, the factory premises of a debtor owing the company $21 600 at 31 March 2006 were destroyed by fire. As a result, the debtor was placed into liquidation. Initial indications are that Wilt Extra Limited will receive no dividend on liquidation. The tax rate is 30 per cent.
- ♦ Included in the 'other miscellaneous expenses' is an amount of $13 700 relating to administration expenses and $6850 relating to freight charges.
- ♦ Auditors' remuneration of $4652 includes an amount of $552 for their expenses. The auditors have indicated that a further amount of $2500 should be provided for audit fees.
- ♦ The company has three directors, J.H. Hart, R.D. Ross and G.L. Swag. J.H. Hart received remuneration of $132 945 for the year, while R.D. Ross received

  $99 546. The company paid professional subscriptions amounting to $1 054 for R.D. Ross and debited it to the Subscriptions account in the ledger. G.L. Swag, who was appointed on 1 March 2006, received remuneration of $3500. Salaries paid to the directors were debited to the salaries and wages account in the ledger. Three employees who work in the office were each paid $31 000.
- ♦ On 3 July 2005, J.H. Hart acquired 200 000 ordinary shares in the company.
- ♦ A dividend of 3 cents per ordinary share on hand at 31 March 2006 should still be provided for.
- ♦ Taxation of $86 306 must still be provided for. This has been correctly calculated.

Required

Prepare the financial statements of Wilt Extra Limited for the year ended 31 March 2006 from the information provided. These financial statements should comprise:

- ♦ a statement of financial performance by function
- ♦ a statement of financial position
- ♦ a statement of recognised income and expenses
- ♦ the accompanying notes.

Prepare the financial statements so as to comply with the express requirements of the *Companies Act 1993* and generally accepted accounting practice. It is not necessary to provide accounting policy notes or a statement of cash flows.

46 Sharp Limited manufactures electronic equipment used by university students to assist them when they prepare for, and take, accounting exams. The following list of balances has been extracted from the accounting records of Sharp Limited at 31 December 2006.

	Dr $	*Cr* $
Advertising	24 780	
Audit fee	9 600	
Bank charges	2 550	
Bad debts	11 553	
Cost of sales	3 566 556	
Depreciation	9 729	
Directors' remuneration	114 880	
Dividends paid	560 000	
Dividend received		2 670
Gain on sale of investment		124 420
Interest paid	12 980	
Interest received		1 236
Gain on expropriation of land		455 000
Other expenses	2 445 120	
Rates	6 270	
Sales		5 684 320
Surplus on revaluation of land		220 000

The following additional information is available:

- ♦ An analysis of 'other expenses' shows that as part of their philanthropic activities for the year, an amount of $1550 was paid to a political party after an approach from the party leader, while an amount of $4900 was paid to an environmental lobby group. Also included in 'other expenses' is an amount of $1 234 876 paid out to three disgruntled students who alleged that the claims made by the company that they would pass their examinations if they used its 'Accounting Genius 232-43' when doing their exam preparation could not be substantiated. Donations are not deductible for tax purposes.
- ♦ Bad debts include a write-off of $8440 that resulted from the liquidation of a major debtor. The balance of the bad debts was as a result of normal business activities.
- ♦ The gain on expropriation of land occurred when the Wellington District Council expropriated a portion of the company's land with a carrying value of $560 550 and made payment of $1 015 550. Wellington District Council plans to construct a multidimensional X-games park on the land. In terms of a binding ruling from the Inland Revenue Department, the surplus on the expropriation of land will be subject to taxation.
- ♦ The gain on the sale of the trading investment arose from the sale of its shares in a company in Malaysia. The shares were originally purchased to ensure a reliable supply of computer chips for use in the manufacture of their electronic equipment. However, quality control issues at the production facilities meant that these computer chips were unsuitable for their intended purposes. It is uncertain whether Sharp Limited will make any further investments of this nature. As this gain is of a capital nature, it is not subject to taxation.

- The surplus on the revaluation of land is not assessable for taxation purposes as it has not been earned.
- No provision has been made for taxation. The taxation rate is 30 cents in the dollar. Dividends received are not subject to taxation.
- Opening equity amounted to $8 428 888.

Required

Prepare the statement of financial performance by nature and statement of changes in equity, together with supporting notes, for Sharp Limited for the year ending 31 December 2006. Ignore accounting policy notes. Comparative figures are not required.

Note: Only those notes that can reasonably be determined from the information should be provided.

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