

First-Time Adoption of International Financial Reporting Standards

Discussion Paper

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1. Executive Summary



On 16 June 2003, IFRS-1: *First-Time Adoption of International Financial Reporting Standards* (IFRS-1) was issued by the International Accounting Standards Board (IASB) to be effective for financial years beginning on or after 1 January 2004. An exposure draft of the equivalent New Zealand standard (ED NZ IFRS-1) has also been released by the Financial Reporting Standards Board (FRSB) for comment by 31 January 2004.

ED NZ IFRS-1 outlines the process for transition from New Zealand generally accepted accounting practice (NZ GAAP) to International Financial Reporting Standards (IFRS). In New Zealand, the FRSB is currently adapting IFRS to ensure that public sector and not-for-profit entities will be able to comply with the standards. These adapted standards will be known as New Zealand international financial reporting standards (NZ IFRS). As a result, ED NZ IFRS-1 will effectively apply on first time adoption of NZ IFRS, expected for financial periods beginning on or after 1 January 2007, with early adoption permitted for periods beginning on or after 1 January 2005.

The proposed requirements of ED NZ IFRS-1 are as follows:

- NZ IFRS will need to be retrospectively applied when first adopted, with certain limited mandatory and optional exceptions;
- an NZ IFRS compliant opening balance sheet will have to be prepared for the beginning of the earliest comparative period presented, and
- comparative information will need to be fully restated to comply with NZ IFRS. For entities which elect to adopt early, this could be as soon as 1 January 2004 for entities with December year-ends.

An entity will be prohibited from retrospective application on matters related to:

- derecognised financial assets and financial liabilities;
- hedge accounting; and
- measurement of estimates.

An entity may elect to use one or more exemptions relating to the following:

- choosing not to retrospectively apply NZ IFRS to prior business combinations;
- choosing not to provide comparative information on financial instruments where NZ IFRS is adopted before 1 January 2006;
- using current fair value or certain prior revaluations as deemed cost for certain non-financial assets;
- using previous event driven fair value measurements;
- electing to recognise all cumulative actuarial gains and losses at the date of transition relating to the measurement of a defined benefit pension asset or liability;
- deeming cumulative translation differences for all foreign operations to be zero at the date of transition;
- not recognising the component parts of certain compound financial instruments; and
- using certain measurement options where entities (or associates or joint ventures) in a group become IFRS compliant at different dates.

In many respects, entities are given a 'fresh start' and will be required to redetermine their accounting policies under NZ IFRS, fully restating past comparative information.

The limited optional exceptions will also present some opportunities for entities to determine optimal outcomes.

The information in this document is based on New Zealand and International standards and exposure drafts current as of 30 November 2003. A number of standards expected to be effective in 2005 are still to be issued, either as final standards or even as exposure drafts. Where relevant, reference is made to exposure drafts on issue or projects currently being undertaken. Readers of this Discussion Paper should note that the due process being followed internationally and in New Zealand may result in final standards which are different to the current proposals.

However, with the IASB reissuing the majority of the existing IFRS on issue, and more than 30 new NZ IFRS expected by mid 2004, entities will face a significant challenge in determining the impacts of convergence.

This paper does not address in detail all the options available and current differences between New Zealand accounting standards and IFRS, but attempts to highlight the key issues an entity will face when NZ IFRS are first applied. Adoption of IFRS is not just an accounting issue, as significant business issues will also arise because of convergence. These issues will need to be addressed in an entity's implementation plan to ensure a smooth transition to the new regime.

Entities should not underestimate the business implications and the amount of work involved. The planning and approach to convergence with IFRS needs to be considered by all entities now.

2. Harmonisation in New Zealand



The Financial Reporting Standards Board (FRSB) has for a number of years been developing accounting standards with a view to international harmonisation. However in the past year the harmonisation policy has changed to a 'convergence' approach, whereby the FRSB intends to adopt IFRS as equivalent New Zealand Standards (NZ IFRS), with some minor exceptions. This change was a result of the Accounting Standards Review Board (ASRB) recommendation in December 2002 that reporting entities be required to apply IFRS from 1 January 2007 with early adoption allowed from 2005.

Although subject to the IASB adhering to their timetable, the FRSB intends to issue over 30 new or revised accounting standards by mid 2004. These will apply to all entities deemed to be 'reporting entities', however it remains unclear at this stage which entities will be encompassed by the term 'reporting entity'. The Ministry of Economic Development is due to release a discussion paper on this topic in the near future. Due to the inter-relationships that exist within IFRS, the FRSB has adopted a 'big-bang' approach to convergence and all these financial reporting standards will be applicable from 1 January 2007 (2005 for early adopters)¹.

It is intended that the new/revised accounting standards will converge with IFRS, however as part of due process, in addition to some specific issues on several IFRS, the FRSB is adding some material to the international standards to enable public benefit entities (public sector and not-for-profit entities) to be able to comply with the standards. The FRSB will seek opinions on whether:

- the additional requirements for public benefit entities are reasonable, or any further requirements are needed;
- there are any regulatory or other issues arising in the New Zealand environment that may affect the implementation of IFRS; and
- there are any issues relating to the Privacy Act 1993.

The impact of convergence with IFRS will vary from entity to entity, depending on structure, operations, transactions and historical accounting policies. Despite New Zealand's previous harmonisation policy, a number of significant differences remain between IFRS and NZ GAAP. There are also a myriad of minor differences that many entities will need to identify and resolve, and most IFRS are also expected to be revised between now and 1 January 2005. In addition, there are a number of ongoing projects in various areas. As a result, the exact nature and requirements of accounting standards that New Zealand entities will apply from 1 January 2007 (2005 for early adopters) will not be known until at least mid 2004. New Zealand entities will therefore need to consider the transition process in the context of concurrent changes.



For further details on the harmonisation approach being adopted in New Zealand, refer to the Deloitte publication 'International Financial Reporting Standards Healthcheck 2003', available at www.deloitte.co.nz

¹ It should be noted however that where there is currently a gap in the New Zealand suite of standards (for example accounting for employee benefits and financial instruments), it is possible that a New Zealand specific standard may be issued with an earlier application date.

3. Application in New Zealand



Throughout the remainder of this publication reference will be made to the relevant IFRS since the corresponding NZ IFRS are expected to be virtually identical with the exception of additional material for public benefit entities and the deletion of certain options.

3.1. Objective of IFRS 1

The objective of IFRS-1 is to achieve high quality financial reporting amongst entities reporting under IFRS through information that:

- is transparent to users and comparable over all periods presented;
- provides a suitable starting point for the entity's subsequent accounting under IFRS; and
- can be generated at a cost that does not exceed the benefit to users.

To achieve this objective, IFRS-1 provides the framework to be adopted when an entity adopts IFRS and imposes overriding transitional provisions, which must be applied on first-time adoption. In principle IFRS-1 requires retrospective application of each IFRS effective at the reporting date of an entity's first IFRS compliant financial statements, with certain limited exceptions as detailed in sections 4 and 5.

3.2. Application Date

3.2.1. General Requirements

IFRS-1 is applicable to entities adopting IFRS for the first-time as their basis of accounting for periods beginning on or after 1 January 2004. A first-time adopter is an entity that, for the first-time, makes an explicit and unreserved statement that its general purpose financial statements comply with IFRS. In New Zealand, as New Zealand accounting standards will continue to exist, it is expected that first-time adoption will be considered in the context of NZ IFRS applicable for financial periods beginning on or after 1 January 2007 (with early adoption permitted from 1 January 2005). The first time adopter will make an explicit and unreserved statement that its general purpose financial statements comply with IFRS².

A 'first-time adopter' includes entities that may have prepared IFRS financial statements for internal management purposes only, or stated compliance only with limited IFRS, but does not include entities who reported under both New Zealand GAAP and IFRS, or reported under IFRS and received a qualified audit opinion.

IFRS-1 requires the restatement of at least one year of comparative information, therefore the principles of IFRS-1 may effectively be applicable from 1 January 2006 (1 January 2004 for early adopters). However, an earlier effective application date may apply where an entity elects or is required by regulatory requirements to restate more than one year of comparatives.

To assist in the restatement of comparatives, an opening balance sheet at the 'date of transition' should be prepared, the date of transition being the date at the beginning of the earliest comparative period restated. IAS-1: *Presentation of Financial Statements* requires at least one year of comparatives. If additional comparative periods are presented, an entity can choose whether or not to restate these additional periods. Where additional comparative information is presented under New Zealand (or another) GAAP, an entity shall label the information as such and disclose the nature (quantification not required) of the main adjustments to comply with IFRS. There are special provisions for US foreign private issuers (refer 3.2.3).

² In New Zealand entities will state compliance with NZ IFRS. Profit oriented entities, who are not affected by the additional guidance for public benefit entities, will also be able to assert compliance with IFRS.

3.2.2. Interim Financial Reporting

IFRS-1 applies equally to annual reporting periods and interim financial reporting periods presented under IAS-34: *Interim Financial Reports*. Therefore, half-year financial statements in the year the first IFRS financial statements are prepared will also be impacted.

Therefore, the key dates for IFRS compliant information for the most common reporting dates in New Zealand are expected to be:

	Early Adoption 1 January 2005			Adoption 1 January 2007		
Year end	31 Dec	31 March	30 June	31 Dec	31 March	30 June
Date of transitional balance sheet	01/01/2004	01/04/2004	01/07/2004	01/01/2006	01/04/2006	01/07/2006
Half-year restated comparatives (where applicable)	30/06/2004	30/09/2004	31/12/2004	30/06/2006	30/09/2006	31/12/2006
Full year restated comparatives	31/12/2004	31/03/2005	30/06/2005	31/12/2006	31/03/2007	30/06/2007
IFRS compliant half-year financial report (where applicable)	30/06/2005	30/09/2005	31/12/2005	30/06/2007	30/09/2007	31/12/2007
IFRS compliant financial report	31/12/2005	31/03/2006	30/06/2006	31/12/2007	31/03/2008	30/06/2008

3.2.3. US Foreign Private Issuers

New Zealand entities that are US foreign private issuers are required to present a minimum of two years of comparative information in the income statement and statement of cash flows in their financial statements lodged with the US Securities and Exchange Commission (SEC) under Form 20-F. In accordance with SEC Rules, all periods presented must be prepared using the same basis of accounting. Therefore, US foreign private issuers must restate at least two years of comparatives, causing their date of transition to be one year earlier than other New Zealand companies.

For selected financial data, an additional two years of information is required, but this information may be omitted where the information cannot be provided, or cannot be provided on a restated basis, without unreasonable effort or expense. The SEC has however stated that registrants should provide whatever information is available for the additional two years that is IFRS compliant.

As a consequence of these requirements, it is possible that a New Zealand entity could have two different dates of transition where the New Zealand financial report only includes one year of comparatives. In such a case, given the exceptions outlined in section 5 to the general principle of full retrospective application, assets and liabilities may be recognised and measured differently for New Zealand versus US GAAP reporting. This may require, on an ongoing basis, the need to maintain two sets of accounting records and therefore it may be judicious to ensure the comparative periods restated and presented in the two sets of financial statements are consistent.

3.2.4. Early Adoption

While entities are not required to adopt NZ IFRS until 1 January 2007, early adoption is permitted from 1 January 2005 in order to coincide with the requirement for European Union listed companies and Australian reporting entities. IFRS-1 has not yet been issued as a New Zealand Standard and therefore cannot yet be adopted by New Zealand entities. The standard is expected to be issued by early 2004 to ensure guidance is in place for those who choose to adopt NZ IFRS early for periods beginning on or after 1 January 2005.

3.3. Which Accounting Standards?

The core group of international standards are expected to be issued as finalised NZ IFRS by mid 2004 to allow for early adoption. Financial reporting standards issued and effective as at the reporting date of an entity's first IFRS compliant financial statements, should be used. For example, an entity choosing to adopt early with a 31 December 2005 financial year end would adopt those standards effective for financial periods beginning on or after 1 January 2005.

Therefore, even though a standard may not have been issued as at the date of transition (that is, 1 January 2004 in the preceding example), it should still be applied retrospectively as if there was no preceding accounting standard with potentially different requirements. Note, many of the NZ IFRS may not be issued until mid 2004 but will be effective at the reporting date when all NZ IFRS are adopted.

It is also possible to adopt a standard whose application is not yet mandatory for the reporting period but where early adoption is permitted. The IASB has a number of projects currently on its agenda where standards are expected to be finalised prior to 1 January 2005 with application dates beyond 1 January 2005, for example, performance reporting and business combinations phase II. If equivalent standards are adopted in New Zealand prior to the end of the first reporting period when all NZ IFRS are adopted, these later converged standards may be early adopted at that time.

Changes to current IASB Standards may arise due to current IASB projects but also due to amendments made by the FRSB on adoption as NZ IFRS. Recent exposure drafts issued by the FRSB have shown that in certain cases the FRSB intends to still specify that some choices under IFRS will not be available under NZ IFRS. Therefore, we are still aiming at a moving target.

Current New Zealand accounting standards apply equally to large and small corporates, not-for-profit entities and the public sector, and such application is expected to continue under NZ IFRS. The IASB's focus is on major corporate reporting entities and as such issues in relation to public benefit entities may not have been fully explored. The FRSB is addressing this issue by providing additional guidance where required. Additions or changes to the IASB standards are clearly marked in the NZ IFRS.

4. General Principles



4.1. Overview

As explained in section 3.2, an entity must prepare an opening IFRS balance sheet at the date of transition to IFRS. In general, IFRS-1 requires retrospective application of IFRS effective at the reporting date of the entity's first IFRS financial report. As a result an entity's opening balance sheet must, except for the limited exceptions discussed in section 5:

- recognise all assets and liabilities whose recognition is required by IFRS;
- not recognise items as assets or liabilities if IFRS do not permit such recognition;
- classify recognised assets, liabilities and components of equity in accordance with IFRS; and
- apply IFRS in measuring all recognised assets and liabilities.

Any adjustments resulting from the restatement of the opening balance sheet shall be recognised directly in retained earnings, or if appropriate another category of equity, at the date of transition.

In the following sections, the impacts of these requirements are discussed with reference to certain standards where specific interpretive issues might arise. These should be considered in conjunction with the exemptions discussed in section 5.

4.2. Options Within Accounting Standards

On first-time adoption of IFRS, an entity must choose which accounting policies will be adopted. Certain IFRS provide an entity with an explicit choice between alternative accounting policies that may be applied in preparing financial statements. This choice may have a significant impact on future results. Once adopted, an accounting policy should only be changed where the change will result in a more appropriate presentation, therefore opportunities to change may be restrictive.

Examples of areas where there is a choice of accounting policies under IFRS include, but are not limited to:

- Expensing versus capitalisation of borrowing costs (IAS-23);
- Cost versus revaluation basis of accounting for property, plant and equipment and intangible assets (IAS-16, IAS-38);
- Cost versus fair value basis of accounting for investment property (IAS-40);
- Treatment of investments in subsidiaries and associates in parent entity financial statements either at cost or at fair value under IAS-39 available-for-sale accounting (IAS-27, IAS-28, as proposed in the Exposure Draft: *Improvements to International Accounting Standards*);
- Proposed choice to designate any financial instrument as held-for-trading (IAS-39);
- Hedge accounting (IAS-39); and
- Proportionate consolidation versus equity accounting of jointly controlled entities (IAS-31).

Before the measurement stage of first-time adoption can commence, decisions need to be made on which policies will be adopted. However, entities making such decisions need to be aware that certain choices within IFRS may be excluded by the FRSB under NZ IFRS.

4.3. Major Interpretative Issues

4.3.1. Intangible Assets (Excluding Goodwill)

The full retrospective application of IAS-38: *Intangible Assets* requires the recognition of only those intangible assets that meet the recognition criteria of IAS-38, that is:

- it is probable that future economic benefits will flow to the entity; and
- the cost can be reliably measured.

No New Zealand financial reporting standard comprehensively addresses accounting for intangible assets. The only guidance is ED-87: *Accounting for Intangible Assets* which is based on IAS-38. Improvements to IAS-38, and the lack of an approved financial reporting standard has resulted in certain accounting practices in New Zealand not being compliant with IAS-38 (refer to the comparison below).

These criteria should not be assessed at the date of transition, but assessed at the time the costs were initially incurred, with no adjustments for hindsight. Therefore, at the date costs were initially incurred an entity must have had systems in place to make an assessment of future economic benefits and for accumulating costs. As with any intangible assets, where the recognition criteria is met at a later date, amounts originally expensed cannot be reversed and capitalised, only costs from the point the criteria are met are eligible for capitalisation. Amounts recognised or derecognised should include equivalent amortisation.

Normally any adjustments arising from the recognition or derecognition of intangible assets will be made through opening retained earnings. However where the intangible asset arose in a business combination, the adjustment should be made against goodwill as detailed in section 5.2.1. In such cases there are modified measurement conditions.

In addition, the deemed cost exemption, as detailed in section 5.2.2 is also applicable to intangible assets, however its application is limited to intangible assets which can be revalued to fair value under IAS-38. Such revaluations are only permitted where there is an active market, for which there are limited examples in New Zealand.

IFRS versus New Zealand GAAP Comparison

IAS-38 requires that intangible assets must be recognised where they meet the 'identifiability' criteria - either the asset is 'separable' or arises from contractual or legal rights. Therefore intangible assets cannot be ignored and subsumed into goodwill in a business combination. As detailed in section 5.2.1, even though a prior business combination may not be restated, intangible assets that still exist at the date of transition cannot be ignored and must be separately recognised where the subsidiary is able to meet the recognition and measurement criteria. Other differences between New Zealand GAAP and IAS-38 that may cause adjustments include:

- A prohibition on the recognition of internally generated brands, mastheads, publishing titles, customer lists and similar items as assets. Where such assets are currently recognised under New Zealand GAAP these must be derecognised;
- Revaluation of intangible assets would be restricted to fair value determined by reference to an active market, that is, without an active market no revaluation is permitted. It is uncommon in New Zealand for an active market to exist for an intangible asset. An active market cannot exist for intangible assets such as brand names, newspaper mastheads, music and film publishing rights, patents, and trademarks, as each of these assets is unique by its nature;
- A prohibition on the capitalisation of expenditure related to start-up, training activities, advertising, promotional, relocation and other similar activities;
- The non-amortisation of intangible assets that have an indefinite life;
- Residual value is assumed to be zero unless there is a commitment by a third party to purchase the asset or there is an active market for the asset.

4.3.2. Impairment of Assets

At the date of transition, an impairment test under IAS-36: *Impairment of Assets* should be performed for most current and non-current assets where there is an indication of impairment. The impairment methodology under IAS-36 is more comprehensive than the guidance in FRS-3: *Accounting for Property, Plant and Equipment* and therefore this in itself may necessitate the need for an impairment test.

As noted in section 5.1.3, the estimates used in the methodology to calculate recoverable amount should be consistent with estimates previously made at the same date under New Zealand GAAP.

It is possible that an impairment write-down or reversal of a write-down will be required at the date of transition despite no underlying change to the entity.

Where an impairment loss or reversal is recognised at the date of transition, disclosures will be required similar to those had the write-down occurred in a normal reporting period, and any adjustments should be recognised through opening retained earnings.

IFRS versus New Zealand GAAP Comparison

Differences between FRS-3 and IAS-36 (as amended) that may cause adjustments include:

- In determining an assets value-in-use:
 - future cash flows must be discounted – the discount rate is determined on a pre-tax basis and future cash flows are also determined on a pre-tax basis; and
 - there are restrictions on what information and assumptions can be used when determining future cash flows – particularly in relation to future capital expenditure and growth rates used.
- Goodwill acquired in a business combination must be allocated to the smallest individual cash generating unit (CGU) by the end of the first annual reporting period beginning after acquisition and will be subject to an annual impairment test for the CGU to which it relates.
- Impairment losses are not reversed in relation to goodwill.

4.3.3. Classification of Financial Instruments

The full retrospective application of IAS-32: *Financial Instruments: Disclosure and Presentation* would require the classification of financial instruments issued as either financial liabilities or equity instruments in accordance with the substance of contractual arrangements when the instrument first satisfied the recognition criteria, without considering events subsequent to that date, other than changes to the terms of the instrument.

An exemption has been created in relation to compound financial instruments where the liability component is no longer outstanding, refer section 5.2.6, but otherwise no exemptions exist.

IFRS versus New Zealand GAAP Comparison

There is currently no specific guidance in New Zealand on the classification of financial instruments as either financial liabilities or equity instruments and there are a variety of practices. Differences may exist therefore in relation to:

- Obligations that can be settled with the issuer's own equity instruments;
- Financial instruments with contingent settlement provisions beyond the control of both the issuer and the holder;
- Redeemable financial instruments, for example, units in unit trusts and resetting preference shares;
- Equity-based derivatives; and
- Compound financial instruments.

The IASB has tentatively agreed to make a number of changes to the proposals in its exposure draft as a result of comments received. Those changes relate to (among others):

- Derecognition
- Reversal of impairment losses
- Macro hedging
- Basis adjustment

A summary of changes proposed is at:
www.iasplus.com/agenda/ias39rev.htm

4.3.4. Recognition and Measurement of Financial Instruments

In its September 2003 meeting the IASB tentatively agreed to amend IFRS-1 to permit entities adopting IFRS for the first time in 2005 to not restate comparative financial statements to incorporate the requirements of IAS-32 and IAS-39. However, a reconciliation between the amounts recognised at the end of the comparative period and those recognised at the beginning of the next period will be required. The main reason for this is because the standard is not expected to be finalised with enough time for 2005 adopters to have comparatives which will comply with the standard. In addition, the IASB has tentatively decided that retrospective adoption is not required for previously derecognised financial assets and financial liabilities (refer section 5.1.1) and hedge accounting (refer section 5.1.2). As such, in general all financial assets and financial liabilities should be recognised in the entity's year of transition and measured in accordance with their designation under IAS-39.

IAS-39 requires financial assets to be designated to one of four sub-classifications for which different measurement requirements apply. Once designated an asset cannot be reclassified between categories unless either:

- there is evidence of a recent actual pattern of short-term profit taking that justifies such reclassification; or
- the financial asset is a held-to-maturity investment which is sold prior to maturity in which case the entire portfolio of such assets must be reclassified as either available-for-sale or held-for-trading and remeasured to fair value.³

Classification	Measurement	Recognition
Held-for-trading	Fair value	Profit or loss
Available-for-sale	Fair value, subject to impairment	Equity ⁴
Originated loans and receivables ⁵	Amortised cost, subject to impairment	Profit or loss
Held-to-maturity	Amortised cost, subject to impairment	Profit or loss

³ The IASB Exposure Draft Proposed Amendments to IAS-32: *Financial Instruments: Disclosure and Presentation* and IAS-39: *Financial Instruments: Recognition and Measurement* proposes to eliminate the option to reclassify a financial asset as held-for-trading post initial designation. On the tainting of a held-to-maturity financial asset portfolio, reclassification will be as an available-for-sale financial asset, rather than held-for-trading. Otherwise there is no ability to reclassify available-for-sale financial assets.

⁴ The IAS-39 Exposure Draft proposes to eliminate the current option of recognising changes in fair value in the profit or loss, however it will allow any financial asset to be designated as held-for-trading.

⁵ Several tentative decisions have been made by the IASB for this category of assets. Purchased loans can be classified as originated loans if they meet the criteria for originated loans (and not purchased for trading). The definition may also be amended to restrict the category to exclude those loans and receivables where the holder may not recover substantially all of its initial investment other than because of credit deterioration.

⁶ The IASB has tentatively agreed to permit any financial asset or liability to be measured on initial recognition at fair value with gains and losses through profit or loss.

At the date of transition, the following guidance applies to the allocation of financial assets to these classifications:

- For held-to-maturity investments, the classification should reflect the entity's intent and ability at the date of transition. Therefore sales and transfers before the date of transition do not trigger the 'tainting' provisions.
- For loans and receivables originated by the entity, reference should be made to the circumstances at the date the asset was initially recognised.
- For financial assets held-for-trading, classification of non-derivative financial assets requires that the asset:
 - was acquired principally for the purpose of selling in the near term; or
 - at the date of transition, was part of a portfolio of identified financial instruments that were managed together and for which there was evidence of a recent actual pattern of short-term profit taking.⁶
- Derivatives (including embedded derivatives) are always deemed held-for-trading.

Similar requirements exist in relation to financial liabilities, however there are only two sub-categories, held-for-trading financial liabilities that are measured at fair value with changes in fair value recognised in the profit or loss, and other financial liabilities that are measured at amortised cost. In designating financial liabilities between these two categories, the above comments in relation to held-for-trading financial assets equally apply.

For those financial assets and financial liabilities that are measured at amortised cost, the cost should be determined based on the circumstances existing when the assets and liabilities first satisfied the recognition criteria. Financial assets and financial liabilities acquired in a business combination may be measured at their deemed cost in accordance with historical acquisition accounting under New Zealand GAAP under the specific exception discussed at 5.2.1.

Adjustments on initial adoption of IAS-39 should be recognised against opening retained earnings other than in relation to available-for-sale financial assets for which fair value adjustments should be recognised in a separate component of equity until the asset is derecognised or impaired.

IFRS versus New Zealand GAAP Comparison

Financial assets under New Zealand GAAP may be recognised at cost, fair value or net market value depending on the entity and the assets involved. Therefore the impact of convergence will vary between entities.

No specific guidance exists under New Zealand GAAP for the subsequent measurement of financial liabilities and these would normally be recognised at amortised cost.

The requirement for financial assets and financial liabilities to be recognised on-balance sheet under IAS-39 will result in more derivatives being recognised. To understand the impact of this requirement, refer to the discussion at 5.1.2.

A full inventory of financial assets and financial liabilities should be performed at the date of transition and the impact of alternative designation choices under the proposed revised IAS-39 considered. This inventory will include derivatives embedded within host contracts that are not necessarily financial instruments, such as leases and loan commitments. Such embedded derivatives may need to be accounted for separately.

4.3.5. Income Taxes

IAS-12: *Income Taxes* introduces a complex change in accounting for income taxes with the change to the balance sheet method on a comprehensive basis. Deferred tax is based on temporary differences not timing differences (a temporary difference is the difference between the accounting carrying value and the tax base of an asset or liability, e.g. IAS-12 will include deferred taxation in relation to the revalued portion of property, plant and equipment).

IFRS versus New Zealand GAAP Comparison

IAS-12 results in deferred tax assets and liabilities being created for temporary differences not timing differences. Some of the areas where IAS-12 may have a significant impact are:

- Fair value adjustments in acquisitions;
- Asset revaluations;
- Compound financial instruments;
- Translation of foreign operations;
- Undistributed profits/impairments of investments in subsidiaries, associates and joint venture entities;
- No discounting of deferred taxation balances; and
- Recognition of deferred tax assets based on probable criteria instead of virtual certainty.

On first-time adoption, the deemed cost exemptions discussed in 5.2.2 and other exemptions may change the carrying values of assets and liabilities. The tax effect of such revisions should also be incorporated into any retained earnings adjustment. Therefore a full review of the impact of IAS-12 will need to be performed at the date of transition.

4.3.6. Borrowing Costs

The full retrospective application of IAS-23: *Borrowing Costs* requires an entity to first determine whether they will adopt a policy of capitalising or expensing borrowing costs.

Where an entity elects to adopt the benchmark treatment under IAS-23 of expensing all borrowing costs, retrospective application would require the entity to determine the amount of capitalised borrowing costs currently included in the carrying amount of assets and derecognise these amounts. Where such amounts cannot be determined, an entity will be required to apply one of the deemed cost exceptions discussed at section 5.2.2.

The allowed alternative treatment under IAS-23 is to capitalise borrowing costs related to qualifying assets. The treatment is similar to that required under FRS-3: *Accounting for Property, Plant and Equipment*. An entity electing to continue with this policy would therefore not need to make an adjustment, except for the instance where borrowed funds are temporarily invested. IAS-23 requires the interest costs capitalised to be reduced by investment income, whereas FRS-3 requires the interest costs capitalised to be limited to the cost of borrowings that actually funded expenditure during the period.

4.3.7. Share-Based Payments

ED-93: *Share-Based Payment* was a request for comment on the IASB ED-2: *Share-Based Payment*. It includes prospective transitional provisions based on the date of the issue of the exposure draft being November 2002, but does not propose any amendments to the requirements of IFRS-1. Therefore, as the exposure draft is currently written, its requirements will apply to a first-time adopter retrospectively, irrespective of the date on which the share-based payments were granted.

The IASB have indicated that with all new standards they will consider the transitional requirements separately for an entity that currently reports under IFRS and a first-time adopter. Where retrospective application is not appropriate for a first-time adopter, IFRS-1 will be amended. Therefore we may see amendments to IFRS-1 before it becomes applicable in New Zealand as new IFRS are issued.



Our publication on ED-93: *Discussion Paper: Current Developments in Accounting for Share Based Remuneration* is available at www.deloitte.co.nz

IFRS versus New Zealand GAAP Comparison

No specific guidance exists under New Zealand GAAP. ED-93 requires share-based remuneration, including options and other equity instruments, to be measured at fair value at grant date and recognised in the determination of net profit or loss over the period of service to which the instrument relates (usually the vesting period).

5. Exemptions



Retrospective application of all accounting requirements in sections 5.1.1 to 5.1.3 has been prohibited to prevent inconsistencies with entities already applying IFRS and management discretion being applied with hindsight.

5.1. Mandatory Exemptions

5.1.1. Derecognised Financial Assets and Financial Liabilities

Consistent with the transitional provisions of IAS-39: *Financial Instruments: Recognition and Measurement* financial assets and financial liabilities derecognised (through securitisations, transfers or extinguishment) in a financial year beginning before 1 January 2004 should not be reinstated unless they qualify for recognition as a result of a later transaction or event.

However:

- Any derivatives or other interests (such as servicing rights and obligations in a securitisation) retained after the derecognition transaction and still existing at the date of transition must be recognised; and
- Where the derecognition transaction resulted in a special purpose entity (SPE), the SPE (if it meets the requirements for consolidation) must be consolidated in accordance with SIC-12: *Consolidation – Special Purpose Entities*, regardless of when the SPE was established.

IFRS versus New Zealand GAAP Comparison

There is little specific guidance currently under New Zealand GAAP with regards to the derecognition of financial assets, therefore entities will need to assess their current derecognition policies against the requirements of IAS-39. For example, FRS-26: *Accounting for Defeasance of Debt* allows debt subject to an in-substance defeasance to be treated as being extinguished if certain conditions are met. Such derecognition is not allowed under IAS-39 because the primary debt is not extinguished. Therefore any debt in existence at the date of transition subject to in-substance defeasance, will need to be recognised in the opening IFRS converged balance sheet where the amounts were derecognised post 1 January 2004.

5.1.2. Hedge Accounting

IFRS versus New Zealand GAAP Comparison

Hedge accounting is permitted under IAS-39 in certain circumstances, provided that the hedging relationship is:

- Clearly defined – the risk being hedged and the expected relationship between that risk and the hedging instrument;
- Measurable – the technique used to assess hedge effectiveness; and
- Actually effective – if, despite strategies and expectations, the hedge was not effective, or was only partially effective, either the whole instrument, or only the ineffective portion, is not eligible for hedge accounting.

An entity must designate a specific hedging instrument as a hedge of a change in value or change in cash flows of a specific hedged item. The designation must be in writing, up front (no retrospective designations), and be consistent with an established risk management strategy. In essence, under IAS-39 hedge accounting is not mandatory. If an enterprise does not want to use hedge accounting, it simply does not designate a hedging relationship.

IAS-39 recognises three types of hedges. They are:

- Fair value hedges – a hedge of the exposure to changes in the fair value of an asset or liability that is already recognised in the balance sheet (such as a hedge of exposure to changes in the fair value of fixed rate debt as a result of changes in interest rates). The gain or loss from the change in fair value of the hedging instrument is recognised immediately in net profit or loss. At the same time, the carrying amount of the hedged item is adjusted for the corresponding gain or loss attributable to the hedged risk, which also is recognised immediately in net profit or loss.
- Cash flow hedges – a hedge of the exposure to variability in cash flows relating to:
 - a recognised asset or liability (such as all or some future interest payments on variable rate debt);
 - an unrecognised firm commitment (such as a non-cancellable fixed price purchase order); or
 - a forecasted transaction (such as an anticipated purchase or sale).
 To the extent that the hedge is effective, the portion of the gain or loss on the hedging instrument is recognised initially directly in equity. Subsequently, that amount is included in net profit or loss in the same period or periods during which the hedged item affects net profit or loss (for example, when cost of sales, depreciation, or amortisation are recognised).⁸
- Hedges of a net investment in a foreign entity – these are accounted for as cash flow hedges.

In New Zealand, there are currently rules only in relation to foreign currency hedging which are far less prescriptive compared to IAS-39. Note: the IAS-39 rules extend to any financial instrument, derivative or non-derivative.

On the adoption of IFRS, to prevent the selective designation of hedges to report a particular result, new hedge accounting principles can only be applied prospectively from the date of transition. Therefore:

- Hedge accounting adopted prior to the date of transition will not be restated even if it is inconsistent with IAS-39, whether in relation to measurement, recognition, designation or other requirements.
- All derivatives must be measured at fair value.
- Hedge accounting can only be achieved where the designation, documentation and other criteria of IAS-39 are met at the date of transition.
- For fair value hedges, any gains or losses arising on the (re)measurement of the derivative would be recognised in opening retained earnings consistent with the ongoing recognition of gains or losses in the profit or loss.
- For cash flow hedges, deferred gains or losses previously recognised as assets or liabilities (or not recognised under New Zealand GAAP, for example, foreign exchange contracts) should be reclassified as a separate component of equity where at the date of transition designation and documentation requirements are met.
- Historical effectiveness tests are not required, however these tests must be complied with on an on-going basis.

Example – Cash Flow Hedge – Foreign Currency Swap

On 4 July 2003 Company Y forecasted US dollar purchases of US\$1 million to occur during the first 6 months of 2005. At the same time Company Y entered into a forward foreign currency swap for US\$1 million fixed at US\$0.65. The swap is designated as a hedge of the forecasted purchases and meets all the criteria for a cash flow hedge. Company Y has a 31 December reporting date.

Under New Zealand GAAP the foreign currency hedge was recognised at spot rate at the reporting date and given the forecasted transaction had not yet occurred, the foreign exchange loss was deferred as an asset⁷. Under IFRS, the fair value of the foreign currency hedge should be recognised as a separate component of equity and recognised in the profit and loss when the forecasted transaction occurs.

		New Zealand GAAP	IFRS
	Foreign currency hedge receivable/ (payable)	Deferred (gain)/loss on foreign currency contracts	Separate component of equity
4 July 2003	0	0	0
31 December 2003	(128,205)	128,205	Fair value
31 December 2004	(48,840)	48,840	Fair value

Example – Cash Flow Hedge – Interest Rate Swap

On 1 January 2003 Company X entered into a five-year pay fixed 5.5%, receive BKBM interest rate swap. The notional amount of the interest rate swap was \$10 million, to hedge a \$10 million five-year variable (BKBM) rate debt. The interest rate swap is designated as a hedge of the forecasted interest payments on the debt and meets all the criteria for a cash flow hedge. Company X has a 31 December reporting date and elects to adopt IFRS early.

	BKBM Rate	Fair Value of the Interest Rate Swap
1 January 2003	5.00%	0
31 December 2003	6.57%	406,800
31 December 2004	7.70%	579,300

⁷ The IASB Exposure Draft: Proposed Amendments to IAS-32: *Financial Instruments: Disclosure and Presentation* and IAS-39: *Financial Instruments: Recognition and Measurement* proposes to treat hedges of firm commitments as fair value hedges.

⁸ The IASB has tentatively agreed to allow a basis adjustment in relation to non-financial assets (i.e. the gain or loss would be incorporated in the cost of the asset when this is acquired).

⁹ Typically in New Zealand, the liability for the derivative and the deferred loss (asset) would be netted and no asset or liability recognised.

Under New Zealand GAAP, the fair value of the interest rate swap will not have been recognised, and the effect of the interest rate swap will only have been recognised at the reporting date for the accrual of interest since the last quarterly interest reset date. On transition, an interest rate swap asset of \$406,800 will be recognised at the date of transition with an adjustment recognised in a separate component of equity. The increase in the value of the interest rate swap of \$172,500 in 2004 will also be recognised through the separate component of equity. This will be released to profit or loss as the interest on the debt is expensed.

5.1.3. Measurement of Estimates (Effect of Subsequent Events)

Where estimates are required to be made in determining the opening balance sheet or comparative period information, these estimates should be consistent with estimates made for the same date under New Zealand GAAP. That is, subsequent events should not be taken into account unless there is evidence that the estimates were in error and thus estimates should reflect the same conditions as had been used previously. The only differences that should arise are where there is a change in accounting policy. Therefore, as the calculation of most provisions is consistent between New Zealand GAAP and IFRS, there should not be any opening balance restatements with respect to provisions even when revisions to estimates occurred under New Zealand GAAP in the comparative financial year, provided the revisions to estimates did not reflect errors in the prior financial report. Such revisions to estimates should continue to be recognised in the profit or loss in the comparative financial year.

If an estimate is required under IFRS that was not required under New Zealand GAAP (for example, the calculation of defined benefit plan obligations under IAS-19: *Employee Benefits*), the estimates should not reflect conditions that arose after the date of transition, but reflect market conditions and other expectations at the date of transition.

This ensures that the profit and loss in the first years after the date of transition reflect events as they occur and there are no adjustments through opening retained earnings for facts that wouldn't otherwise have been known at that date. Entities may wish to review estimates that will need to be made under IFRS at the date of transition rather than 2 years later when the first IFRS financial statements are issued. This will eliminate any subjectivity between what is considered to be a post-transition versus pre-transition change in estimate.

Applying the general principles of full retrospective application of all standards was recognised as potentially requiring significant cost without equivalent benefits to the users of the financial statements. As a result, IFRS-1 grants first-time adopters limited exceptions from these requirements in the areas discussed below.

An entity may elect to adopt one or more of these exceptions but they cannot be used by analogy to other items. Where a particular exception is not applied, full retrospective application is required.

5.2. Voluntary Exemptions

5.2.1. Business Combinations

On first-time adoption of IFRS, an entity may elect to:

- not retrospectively restate business combinations recognised prior to the date of transition;
- restate all business combinations post a specific date (earlier than the date of transition); or
- restate all business combinations.

This exemption applies equally to past acquisitions of investments in associates and of interests in joint ventures with respect to the calculation of goodwill for the purpose of equity accounting.

IFRS versus New Zealand GAAP Comparison

There are currently only a few major differences between the requirements of IAS-22: *Business Combinations* and IAS-36: *Accounting for Acquisitions Resulting in Combinations of Entities or Operations*, however if the proposals of NZ ED-94/ IASB ED-3 are approved these differences will extend to include:

- removal of the existing concessions in relation to the recognition of restructuring provisions arising in a business combination;
- in-process research and development will be recognised as an asset, at fair value, when acquired as part of a business combination;
- 'reverse acquisition' accounting would be required in some circumstances;
- 'negative goodwill' (discount on acquisition) will be recognised immediately in net profit or loss; and
- goodwill will not be amortised, but will be subject to an impairment test for the cash generating unit to which it relates, potentially resulting in 'lumpy' profits when an impairment occurs.

It is expected that IASB ED-3/ NZ ED-94 will be effective for financial years beginning on or after 1 January 2005 and therefore would need to be applied at a minimum to acquisitions post 1 January 2004 (December year ends) if early adoption is taken. An entity must consider the following alternatives to determine whether the costs of restatement and other favourable accounting consequences of acquisitions prior to these dates outweigh the benefits that may exist from non-amortisation of goodwill.

5.2.1.1. No Restatement of Business Combinations

Where an entity elects not to restate some or all of its past business combinations, previous acquisition accounting remains unchanged. However the general principles of first-time adoption still apply and thus all, but only those, assets and liabilities whose recognition is required by IFRS are to be recognised. Any adjustments resulting from the application of this principle should be recognised in opening retained earnings, other than adjustments relating to intangible assets as discussed below.

The measurement of all assets and liabilities acquired in a business combination, other than goodwill and intangible assets, as determined under New Zealand GAAP shall be their deemed cost under IFRS. Subsequent to the business combination, the restatement of assets and liabilities to be IFRS compliant should be recognised against retained earnings or other equity, where applicable. Examples include subsequent fair value measurements or where accumulated depreciation calculations are not IFRS compliant.

Assets and liabilities not recognised, but that would have been had IFRS been applied, should be measured on the basis that would be required if the acquiree were a first-time adopter at the same time as the acquirer. As such, the recognition and measurement criteria must be considered from the point of view of the acquiree. For example, contingent liabilities assumed in an acquisition, not previously recognised under FRS-36 will not be recognised under transition to IFRS as the contingent liabilities would not be recognised by the acquiree in its separate IFRS financial statements. Any adjustments resulting from the recognition of such assets and liabilities should be made against opening retained earnings and not goodwill.

The carrying value of goodwill at the date of transition should be its carrying value as previously determined under New Zealand GAAP adjusted for:

- the reclassification of intangible assets (including any related deferred tax and minority interests):
 - to goodwill, where previously separately recognised acquired intangible assets do not qualify for recognition as intangible assets under IAS-38: *Intangible Assets*; or
 - from goodwill, where an intangible asset was not recognised, but would have been had IFRS been applied and the intangible asset still exists at the date of transition. Consistent with the deemed cost principles for other assets and liabilities, such intangible assets should be measured on the basis that would be required if the acquiree were a first-time adopter at the same time as the acquirer, including any required accumulated amortisation reflecting the useful life of the intangible asset, irrespective of the period over which goodwill was amortised. Frequently the recognition and measurement criteria will not be met for intangible assets which are internally generated from the acquiree's perspective because the acquiree will not have had, at the time the original transaction took place, reliable systems for accumulating such costs, or made and documented future economic benefits assessments. (These are specific IFRS requirements for the recognition of internally generated intangibles.) As such it is not expected that significant adjustments will result from this requirement.
- a contingency in relation to purchase consideration which is now reliably measurable and probable. This requirement is consistent with the requirements of FRS-36 and therefore should not lead to the need for any adjustments.
- any impairment loss, following a compulsory impairment test performed in accordance with IAS-36 at the date of transition.

The measurement of minority interests and deferred tax follows from the measurement of other assets and liabilities. Therefore, where adjustments are required to recognise or derecognise assets or liabilities, the effect on minority interests or deferred tax should also be considered.

Example – Application of the Business Combinations Exemption

Entity B's first IFRS financial statements have a reporting date of 31 December 2005 and include comparative information for 2004 only. On 1 July 2001, entity B acquired 100% of subsidiary C. Under New Zealand GAAP, entity B:

- classified the business combination as an acquisition by entity B.
- measured the assets acquired and liabilities assumed at the following amounts under New Zealand GAAP at 1 January 2004:
 - identifiable assets less liabilities for which IFRS require cost-based measurement at a date after the business combination: 200 (with a tax base of 150 and an applicable tax rate of 30 per cent).
 - defined benefit pension liability (for which the present value of the defined benefit obligation measured under IAS-19 is 130 and the fair value of plan assets is 100): nil. The tax base of the pension liability is also nil.
 - goodwill: 180.
- did not, at the date of acquisition, recognise deferred tax arising from temporary differences associated with the identifiable assets acquired and liabilities assumed.

Application of Requirements

In its opening IFRS converged balance sheet, entity B:

- classifies the business combination as an acquisition by entity B even if the business combination would have qualified under IFRS as a reverse acquisition by subsidiary C.
- does not adjust the accumulated amortisation of goodwill. Entity B tests the goodwill for impairment under IAS-36 and recognises any resulting impairment loss, based on conditions that existed at the date of transition. If no impairment exists, the carrying amount of the goodwill remains at 180.
- for those net identifiable assets acquired for which IFRS require cost-based measurement at a date after the business combination, treats their carrying amount under New Zealand GAAP immediately after the business combination as their deemed cost at that date.
- does not restate the accumulated depreciation and amortisation of the net identifiable assets recognised, assuming the depreciation methods and rates under New Zealand GAAP do not result in amounts that differ materially from those required under IFRS. As such, the carrying amount of those assets in the opening IFRS converged balance sheet equals their carrying amount under New Zealand GAAP at the date of transition (200).
- if there is any indication that identifiable assets are impaired, tests those assets for impairment, based on conditions that existed at the date of transition.
- recognises the defined benefit pension liability, and measures it, at the present value of the defined benefit obligation (130) less the fair value of the plan assets (100), giving a carrying amount of 30, with a corresponding debit of 30 to retained earnings.
- recognises a net deferred tax liability of 6 (20 at 30%) arising from:
 - the taxable temporary difference of 50 (200 less 150) associated with the identifiable assets acquired and non-pension liabilities assumed, less
 - the deductible temporary difference of 30 (30 less nil) associated with the defined benefit pension liability.

The entity recognises the resulting increase in the deferred tax liability as a deduction from retained earnings.

Example – Business Combinations – Treatment of Intangible Assets

Entity H acquired a subsidiary before the date of transition. Under New Zealand GAAP, entity H:

- recognised goodwill, carrying value at date of transition: 100.
- recognised an intangible asset of the subsidiary that does not qualify for recognition as an asset under IAS-38. At the date of transition the intangible asset had a net carrying amount of 50.
- did not recognise a brand that had been internally generated by the subsidiary, that had a fair value of 30 at the date of acquisition, as it would have created a discount on acquisition under IAS-36.

Application of Requirements

In its opening IFRS converged balance sheet, entity H:

- does not recognise the intangible asset that does not qualify for recognition as an asset under IAS-38, transferring the balance of 50 to goodwill.
- does not recognise the brand as an intangible asset because it was not recognised in the consolidated balance sheet under IAS-36, and it would not have qualified for capitalisation by the subsidiary under IAS-38 as it was internally generated.
- tests the goodwill for impairment under IAS-36 and recognises any impairment loss, based on conditions that existed at the date of transition.



Restatement of prior business combinations may result in the classification of the acquisition as a reverse acquisition. Reverse acquisition accounting is likely to lead to a lower goodwill value and therefore this may be a consideration in deciding whether to restate prior business combinations.

In cases where an entity was not consolidated under New Zealand GAAP, but is required to be under IFRS, for example in the case of certain special purpose entities, the subsidiary's assets and liabilities should be measured in the consolidated financial statements consistent with measurement in the subsidiary's own separate IFRS compliant financial statements. The deemed cost of goodwill, where the subsidiary was acquired in a business combination and business combinations have not been retrospectively restated, will equal the difference at the date of transition between:

- the parent's interest in the adjusted carrying amount; and
- the cost of the investment in the parent's separate financial statements.

This adjustment results in goodwill (or negative goodwill) effectively representing the net of original purchased goodwill and post-acquisition movements in equity. Where losses have been incurred post-acquisition, goodwill will be greater than original purchased goodwill, but will be subject to an impairment test.

The application of this exemption also applies to the consolidated financial statements of a parent entity that has not historically prepared consolidated financial statements.

Where the subsidiary was created, rather than acquired, no goodwill is recognised. The excess or deficit of the net assets of the subsidiary over the investment should be recognised against retained earnings.

5.2.1.2. Restatement of Some or All Business Combinations

An entity may elect to restate either all historical business combinations or only those business combinations post a particular date. However an entity cannot elect to restate only selected business combinations. In such a case, the most recent version of IAS-22: *Business Combinations* should be applied. Superseded standards that may have existed at the date the actual business combination took place and the transitional provisions of IAS-22 should be ignored.

5.2.2. Deemed Cost for Property, Plant and Equipment, Investment Property and Intangible Assets

On first-time adoption of IFRS, an entity may elect to treat the fair value of the following assets at the date of transition as their deemed cost at that date for subsequent measurement purposes:

- Property, plant and equipment;
- Investment property, where the cost method is adopted under IAS- 40: *Investment Property*; or
- Intangible assets where the IAS-38: *Intangible Assets* recognition criteria are met (including reliable measurement at cost), and the intangible asset would normally qualify for revaluations, that is an active market exists (expected to be rare).

This exemption may be applied irrespective of the previous basis of accounting adopted, and may be selectively applied for different assets within a class of assets.

Other deemed cost exemptions for the above assets are also available but their application is restricted depending on historical accounting policies. When an entity either:

- historically adopted the fair value basis of accounting under FRS-3: *Accounting for Property, Plant and Equipment*, or
- historically adopted a prior revaluation as cost that was:
 - broadly comparable to fair value; or
 - performed through the use of a general or specific price index to a cost broadly comparable to cost or depreciated cost under IFRS;

the last revaluation may become 'deemed cost' under IFRS.

Where the cost basis is adopted, the cost and accumulated depreciation of such assets will need to be determined under NZ IFRS.

IFRS versus New Zealand GAAP Comparison

Adjustments, which may be required to bring New Zealand GAAP cost in line with IFRS, relating to property, plant and equipment and investment property include:

- Government grants, where the entity chooses to deduct grants from the carrying amount of the related asset¹⁰; and
- Accounting for borrowing costs, refer section 4.3.6 for further details.

Refer section 4.3.1 for possible adjustments in relation to intangible assets.

Where the revaluation basis is adopted for property, plant and equipment and intangible assets, an entity is still required to determine what would have been the carrying amount under the cost basis in order to determine the balance that should be recognised in the asset revaluation reserve. (Note, the asset revaluation reserve under New Zealand GAAP will not equate to the asset revaluation reserve under IFRS where increments and decrements within a class of assets have been netted off against one another. This practice is not permissible under IFRS.) Where the amount cannot be determined, the entity uses the deemed cost exemption and the asset revaluation reserve is (re)set to zero if deemed cost is the fair value at the date of transition, or the asset revaluation reserve is (re)set to another amount (being the difference between the deemed costs used and the fair value at the date of transition) if one of the other deemed cost exemptions, adjusted for accumulated depreciation, is adopted.

Example

An entity has elected to adopt the revaluation basis for property on adoption of IFRS.

Historically the entity had adopted FRS-3 during the 2002 financial year. The date of transition for the entity is 1 January 2006.

	Carrying Value at Date of Transition	Original Cost less Accumulated Depreciation (5)	Fair Value at Date of Transition
Property 1 (1)	9,450	9,450	15,000
Property 2 (2)	8,100	6,235	10,000
Property 3 (3)	17,725	Unknown	25,000
Property 4 (4)	5,305	4,050	7,000

- (1) Property 1 was acquired in 2003.
- (2) The carrying value of property 2 represents the fair value of the property established in accordance with FRS-3, adjusted for subsequent depreciation.
- (3) The carrying value of property 3 represents the fair value of the property established in accordance with FRS-3, adjusted for subsequent depreciation.
- (4) Entity D had availed itself of the transitional provisions in FRS-3 which permitted it to continue to carry Property 4 at a valuation which was established before 1 October 1991 (i.e. before SSAP-28, the predecessor to FRS-3, became applicable), adjusted for subsequent depreciation. The pre 1 October 1991 valuation was not based on fair value at that time.
- (5) Calculated in accordance with IFRS.

¹⁰ The IASB has indicated that it intends to revise IAS-20: *Accounting for Government Grants and Disclosure of Government Assistance*.

Application of Requirements:

	Deemed Cost Alternatives Allowed	Asset Revaluation Reserve Created
Property 1	The entity may elect either the original cost, or the current fair value as the deemed cost on initial adoption.	0 or 5,550
Property 2	The entity may elect either the original cost, the FRS-3 valuation, or the current fair value, as the deemed cost on initial adoption.	0, or 1,900 or 3,765
Property 3	The entity may elect either the FRS-3 valuation, or the current fair value as the deemed cost on initial adoption.	0 or 7,275
Property 4	The entity may elect either the original cost, or the current fair value as the deemed cost on initial adoption. The pre 1 October 1991 valuation is not acceptable because it is not broadly comparable to fair value.	0 or 2,950

Where the adjustment is not made to the asset revaluation reserve, the adjustment is be made to retained earnings.

Where the fair value basis is adopted for investment property, the carrying amount under the cost basis does not need to be determined, as changes in fair value are recognised in the income statement, therefore any adjustments at the date of transition should also be recognised in opening retained earnings.

5.2.3. Previous Event Driven Fair Value Measurements

On first-time adoption of IFRS, an entity may elect to carry forward deemed costs of assets and liabilities established under previous GAAP where such deemed costs were based on fair value at a particular date. Such deemed costs may have been created for the purpose of a privatisation or initial public offering in certain countries. Such an event driven measurement exemption is unlikely to be applicable in New Zealand because across the board fair value adjustments could only be created as part of acquisition accounting for consolidation purposes.

5.2.4. Employee Benefits – Defined Benefit Plans

IAS-19: *Employee Benefits* requires an asset or liability to be recognised in relation to defined benefit plans, for example, where they relate to superannuation or medical benefits. The measurement of such balances is dependent on an actuarial valuation. Over time actuarial gains and losses may offset and as such it may be argued that post-employment benefit obligations are best viewed as a range (or 'corridor') around the best estimate. As a result, IAS-19 has permitted actuarial gains and losses within a 10% corridor of the best estimate not to be recognised. On initial adoption of IFRS, an entity may elect to recognise all cumulative actuarial gains and losses at the date of transition, effectively resetting the corridor to zero, even if the 'corridor approach' is to be adopted for subsequent actuarial gains and losses. If an entity has multiple defined benefit plans, this exemption must be applied consistently for all plans.

If this exemption is not adopted and full retrospective application of IAS-19 is performed, an entity would be required to determine actuarial gains and losses for each year since the inception of the plan in order to determine the net cumulative unrecognised gains or losses at the date of transition. In this case, the transitional provisions of IAS-19 cannot be applied.

Note, the current IASB convergence project on employee benefits has considered a proposal requiring all actuarial gains and losses to be recognised immediately, that is the removal of the corridor. An exposure draft and subsequent standard are expected in 2004 and are therefore unlikely to be applicable until post 2005.

This exemption is an opportunity for entities with a loss recognised in their foreign currency translation reserve to write this off to opening retained earnings and start afresh. This is of significance assuming the current requirements of IAS-21 are maintained which requires the recycling of the foreign currency translation reserve on the disposal of such operations.

Irrespective of which method is adopted, it is recommended that actuarial valuations are obtained as the date of transition occurs, rather than two years later at the first financial reporting date under IFRS-1, to ensure that the information necessary to perform the valuation is available. Refer section 5.1.3 regarding the need for estimates to reflect only those conditions that exist at the date of transition.

5.2.5. Cumulative Translation Differences

An entity may elect at the date of transition to not identify cumulative foreign currency translation differences as a separate component of equity in relation to individual foreign operations. In such circumstances, on the subsequent disposal of a foreign operation, cumulative foreign currency translation differences prior to the date of transition cannot be included in the calculation of any gains or losses on disposal. If applied, this exemption must be consistently applied for all foreign operations.

IFRS versus New Zealand GAAP Comparison

The foreign currency translation reserve as determined under FRS-21: *Accounting for the Effects of Changes in Foreign Currency Exchange Rates* although similar, will vary to the calculation under IAS-21: *The Effects of Changes in Foreign Exchange Rates*:

- In consolidated financial statements where goodwill and fair value adjustments exist in relation to the foreign operation. The IASB Improvements Exposure Draft requires goodwill and the fair value adjustments to be translated at the closing rate whereas under New Zealand GAAP they are translated either at the exchange rate at the date of the acquisition (i.e. treated as assets and liabilities of the entity reporting); or at the closing rate (i.e. treated as assets and liabilities of the independent foreign operation).
- On the disposal of a foreign operation, IFRS requires that the amount of exchange differences previously deferred be recognised as income or expense in the period of the disposal. New Zealand GAAP does not allow such recycling of amounts accounted for in reserves.

5.2.6. Compound Financial Instruments

An entity that has issued compound financial instruments but the liability component is no longer outstanding at the date of transition, may elect not to identify the original equity component separately from retained earnings. However, where the liability component is still outstanding on such instruments, the equity component will be required to be recognised.

5.2.7. First-Time Adoption Date Differs for Entities Within a Reporting Entity

A reporting entity and individual entities within the reporting entity may prepare their first IFRS compliant financial statements in different periods. For example, as a result of:

- the New Zealand entity being a subsidiary of an off-shore parent that has complied with IFRS before 1 January 2007; or
- a change in classification to become a reporting entity; or
- an overseas subsidiary, associate or joint venture having complied with IFRS before 1 January 2007 for overseas reporting purposes.

If a subsidiary becomes a first-time adopter later than its parent, at the time the subsidiary becomes a first-time adopter, the subsidiary can measure its assets and liabilities at either:

- Their carrying amounts in the parent's consolidated IFRS financial statements, before considering the effect of business combinations or consolidation procedures; or
- Their carrying amounts determined in accordance with IFRSs based on the subsidiary's date of transition, i.e. in accordance with the requirements of IFRS-1.

Note, if the second alternative is adopted a subsidiary will need to keep two sets of accounting records based on different dates of transition to IFRS. This exemption applies equally to an associate or joint venture where the entity that has significant influence or joint control over it adopts IFRS earlier.

If an entity becomes a first-time adopter later than its subsidiary, associate or joint venture, in the entity's consolidated financial statements the subsidiary's, associate's or joint venture's assets and liabilities may not be restated and must be measured consistently with their historical IFRS financial statements, after considering the effect of business combinations and consolidation or equity accounting adjustments.

A final exemption exists where a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements. In this situation the entity should measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.

6. Disclosures



IFRS-1 does not provide exemptions from the presentation and disclosure requirements of other standards but provides guidance on certain principles, and requires some additional disclosure in the first year of adoption to explain the transition process and the adjustments that have been made. Note, the disclosure requirements of IAS-8: *Accounting Policies, Changes in Accounting Estimates and Errors* in relation to changes in accounting policies do not apply on first-time adoption.

6.1. Comparative Information

As noted in section 3.2, comparative information for at least one financial year needs to be restated as though IFRS have always been applied. Any additional comparative information not complying with IFRS must be clearly labelled as such and disclosure should be made of the main adjustments (no quantification required) that would be required to make the information IFRS compliant.

Historical summaries of selected data included in the financial report do not need to comply with the recognition and measurement requirements of IFRS. However, the nature of the main adjustments (no quantification required) that would be required to make the information IFRS compliant must be disclosed.

6.2. Explanation of Transition to IFRS

In both the first IFRS half-year and annual financial reports, an entity must explain how the transition to IFRS affected the entity's reported financial position, financial performance and cash flows. To achieve this an entity should include:

- In the annual and half-year financial report:
 - A reconciliation of the entity's equity reported in the previous annual financial report to that reported in the first IFRS compliant financial report as at:
 - The date of transition; and
 - The end of the latest annual comparative period¹¹.
 - A reconciliation of the entity's profit or loss reported in the latest annual comparative period to that reported in the first IFRS compliant financial report.
 - An explanation of the material adjustments to the cash flow statement.

When included in the half-year financial report, the above information may be provided through a cross reference to another published document that includes these reconciliations.

- In the half-year financial report the following additional information should be presented:
 - A reconciliation of the entity's equity reported in the previous half-year financial report to that reported in the first IFRS compliant half-year financial report.
 - A reconciliation of the entity's profit or loss reported in the previous half-year financial report to that reported in the first IFRS compliant half-year financial report.

These disclosures should provide sufficient detail to enable users to understand the material adjustments to the balance sheet and income statement, and shall distinguish changes in accounting policy from corrections of errors, where appropriate.

The format of these disclosures may take a number of forms, including either a movement schedule of equity identifying each adjusting item or a comparison of a New Zealand GAAP versus IFRS balance sheet and profit and loss. In both cases, additional notes will most likely be required to further explain the adjustments.

6.3. Other Disclosures

6.3.1. Use of Fair Value as Deemed Cost

If an entity uses fair value at the date of transition as deemed cost, as explained in section 5.2.2, for each line item affected in the opening IFRS balance sheet, the entity must disclose:

- The aggregate of those fair values; and
- The aggregate adjustment to the carrying amount previously reported under New Zealand GAAP.

¹¹ IFRS-1 refers to the end of the latest period presented in the entity's most recent annual financial statements prepared under New Zealand GAAP. Given the annual reporting requirements that exist in New Zealand this will in practice be the latest annual comparative period, but may be another period, or not at all, where a financial report was not required to be prepared in the prior period.

6.3.2. Impairment Losses

If impairment losses were recognised or reversed in preparing the opening IFRS balance sheet, the disclosures that IAS-36: *Impairment of Assets* would have required if the entity had recognised these impairment losses or reversals in a normal reporting period are required. These currently include:

- The amount of impairment losses or reversals recognised in aggregate and by segment;
- The events or circumstances that lead to the recognition or reversals of the impairment losses and the asset or cash-generating unit involved; and
- The basis on which recoverable amount has been determined.

7. Other Resources



The following resources may be useful for further research on first-time adoption of IFRS.

7.1. IASB Pronouncements

The following information can be purchased from the IASB. Refer to the IASB web site: www.iasb.org.uk:

- IFRS-1: *First-Time Adoption of International Financial Reporting Standards*
- Basis for Conclusions on IFRS-1: *First-Time Adoption of International Financial Reporting Standards*
- Guidance on Implementing IFRS-1: *First-Time Adoption of International Financial Reporting Standards*

7.2. Deloitte Information

Deloitte has the following resources to assist you in identifying changes in your financial reporting requirements:

- www.iasplus.com which is a Deloitte website detailing IFRS “as it happens” as well as reporting on the current and proposed output of the IASB.
- www.deloitte.co.nz website for New Zealand based publications such as:
 - Accounting Alert – updates on changes in financial reporting;
 - IFRS in your Pocket - a booklet which summarises key information on each of the existing versions of IFRS and current IASB projects;
 - IFRS Healthcheck 2003 – is your organisation prepared to adopt IFRS?

7.3. Our Experts

For assistance in applying the first-time adoption principles, please contact your Deloitte partner or Denise Hodgkins, National Technical Director.

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Glossary of Terms



Abbreviation/ Term	What it stands for
ASRB	Accounting Standards Review Board (New Zealand)
ED	Exposure Draft
FRS	Financial Reporting Standard
FRSB	Financial Reporting Standards Board (New Zealand)
GAAP	Generally Accepted Accounting Practice
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee – the predecessor to the IASB. The overall structure is now known as the International Accounting Standards Committee or IASC and the 'parent' foundation is the IASC Foundation. The standard-setting body is now called the IASB.
ICANZ	Institute of Chartered Accountants of New Zealand
IFRIC	International Financial Reporting Interpretations Committee of the IASB. Also used to refer to the interpretations issued by this committee.
IFRS	International Financial Reporting Standards IFRS incorporates IAS (inherited by the IASB from its predecessor body the IASC), IFRS (issued by the IASB) and interpretations of both types of standards (SIC, IFRIC).
NZ IFRS	New Zealand International Financial Reporting Standards The FRSB intends to adopt IFRS as New Zealand financial reporting standards (NZ IFRS). IFRS are intended for application by profit oriented entities – additional guidance is incorporated to ensure NZ IFRS are sector neutral.
Public Benefit Entities	Entities whose primary objective is to provide goods or services for a community or social benefit. Incorporates central government, local government and not-for-profit entities.
Reporting Entity	Entities subject to legal requirements on financial reporting. Which entities constitute reporting entities has yet to be defined. A proposal for a new financial reporting structure was reviewed by the ASRB and submitted to the Ministry for Economic Development – the Ministry is expected to issue a discussion paper for public comment on the structure in the near future.
SEC	Securities and Exchange Commission (United States)
SIC	Interpretation(s) issued by the Standing Interpretations Committee of the IASC, the predecessor committee to the IFRIC.
SPE	Special Purpose Entity

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