



Accounting Alert

A Focus on Technical Accounting Issues - Issue Number 6

-
- [FRS-21 : Accounting for the effects of changes in foreign currency exchange rates](#)
 - [Debt or Equity?](#)
 - [Appointments to committees](#)
 - [Accounting for investments in associates](#)
 - [New securities disclosure requirements](#)
 - [Audit and filing requirements for foreign owned companies](#)
 - [Meaning of 'subsidiary' under Financial Reporting Act 1993](#)
-
- [Other Accounting Alert newsletters](#)
-

FRS-21 : Accounting for the effects of changes in foreign currency exchange rates

FRS-21 has been approved by the Accounting Standards Review Board as an applicable financial reporting standard as from periods beginning on or after 1 January 1998. However, the new standard may be applied before the application date, provided the decision to do so is disclosed in the financial statements (per FRS - 1 para 5.20).

FRS-21 "does not deal with accounting for hedging transactions other than the classification of certain exchange differences arising in connection with the hedging of a net investment in an independent foreign operation" (para 1.2). It has therefore become necessary to require continued compliance with a reduced SSAP-21, which will continue concurrently with FRS-21.

The following paragraphs of SSAP-21 (issued in April, 1988), will constitute the revised SSAP-21, which will deal with requirements not covered by FRS-21:

Paragraph Details

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|-----------|--|
| 2 | Application of Standard |
| 3 | Definitions |
| 4.17-4.21 | Hedging of foreign currency assets and liabilities |
| 4.22 | (excluding the first two sentences) Hedged non-monetary matters |
| 4.24 | Hedging of income and expense streams |
| 4.27 | Disclosures re hedging |
| 5.3 | Short term transactions covered by forward exchange contracts |
| 5.5 | Hedging transaction undertaken to establish the price for goods or services purchased or sold |
| 5.6 | Hedging between foreign currency liability and foreign currency non-monetary asset - use of foreign currency transaction reserve |
| 5.8 | Hedging between future income (expense) stream and foreign liability (asset) |
| 5.13(d) | Disclosure of unamortised exchange difference arising from para 5.8 |

When international thinking on the above issues has crystallised the above paragraphs will be revised for inclusion in FRS-21.

Important changes introduced by FRS-21 are:

1. Qualifying entities under the Framework for Differential Reporting are granted the following exemptions:

- They may translate transactions at settlement rate (instead of at transaction date rate), or, if a balance date intervenes before settlement, at spot rate at balance date).
- They need not separately disclose forex gains or losses.

2. The most significant change from both SSAP -21 and ED-80 is the requirement that **revenue and expense items** of an independent foreign operation be translated "using the spot rate at the transaction date or at a rate approximating that rate"

[FRS-21 para 6.5(b)]. Paragraph 6.6 of FRS-21 explains that for practical reasons the average rate is used to obtain a rate that approximates the actual rate.

The need to make this change was highlighted in our commentary on ED-80 in Accounting Alert No.3 entitled "ED-80: A missed opportunity to bring New Zealand into line with world best practice?". It is pleasing to note that a submission by Deloitte Touche Tohmatsu giving practical and conceptual reasons for the need to change from the closing rate method to the average rate method for translating revenue and expense items, and similar letters from large corporates, played a part in achieving the much needed change in New Zealand generally accepted accounting practice.

3. On disposal of an independent operation, the portion of the foreign currency translation reserve which relates to that foreign operation must be transferred out of the foreign currency translation reserve but retained within equity. The transferred item must "not be taken to the statement of financial performance nor recognised in the statement of movements in equity" (a transfer direct to Retained Earnings would satisfy this requirement).

4. If "an integrated foreign operation is reclassified as independent, exchange differences arising on the translation of non-monetary items at the date of the reclassification shall be taken to the foreign currency translation reserve and recognised in the statement of movements in equity".

5. When an independent foreign operation is reclassified as integrated, the translated amounts for non-monetary items at date of the change are retained and treated as the historical cost of those non-monetary items acquired before the change. The portion of the foreign currency translation reserve which relates to the reclassified foreign operation must be treated in the same way as when an independent operation is disposed of, as per 3, above.

Debt or Equity?

The Accounting Framework issued by the International Accounting Standards Committee and the worldwide response through the issue of statements of concepts (in New Zealand, the *Statement of Concepts for General Purpose Financial Reporting*) have caused a radical re-think on the classification between debt and equity. As a result, paragraphs entitled Liabilities and Equity are an important part of the International Accounting Standards on Financial Instruments [IAS-32] and similar standards of some countries.

Gone are the days when shares issued by a company are automatically considered to be equity.

On the other hand, some credit balances which in the past were automatically classified as debt are now a part of equity.

In terms of the *Statement of Concepts*, a liability is a **present** obligation to make **future** sacrifices as a result of a **past** transaction or event. Those, and only those items which comply with all three criteria of the *liability* definition must be classified as debt, and recognised as liabilities if the recognition criteria apply.

More specifically, the International Accounting Standard, IAS-32 and the Australian standard AASB 1033, use definitions of a financial liability and an equity instrument to differentiate between debt and equity.

"The issuer of a financial instrument must classify the instrument, or its component parts, as a liability or as equity in accordance with the substance of the contractual arrangement on initial recognition and the definitions of a financial liability and an equity instrument."

The substance of a financial instrument, rather than its legal form, governs its classification on the issuer's balance sheet. While substance and legal form are commonly consistent, this is not always the case". [AASB 1033/4.1, 4.1.1
Substantially the same as IAS-32/18,19]

The relative definitions are as follows:

"equity instrument means any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities".

"financial liability means any liability that is a contractual obligation:

(a) to deliver cash or another financial asset to another entity; or
(b) to exchange financial instruments with another entity under conditions that are potentially unfavourable".

[AASB 1033/8.1

Substantially the same as IAS-32/5]

Examples

An interest-free loan (eg from a shareholder) which is only repayable at the discretion of the reporting entity, does not comply with the 'contractual obligation' criterion of the *financial liability* definition. It complies with the *equity instrument* definition, and must therefore be classified as equity. A low interest bearing loan which is irredeemable or only repayable as a result of a decision by the borrower, may be partly debt and partly equity in the financial statements of the borf financial performance.

- *Recoverable amount is the greater of net realisable value and value in use.*
- *No exception is granted in regard to temporary declines in value.*

5. Whereas SSAP-8 requires goodwill on acquisition of associates to be included with goodwill on consolidation, ED-81 requires goodwill or discount on acquisition to be identified but included in the *investment in associate* item. Goodwill or discount on acquisition will cause adjustments to be made to share of post-acquisition surpluses by way of amortisation of goodwill and adjustments to depreciation charges caused by discount adjustments to asset values.

6. ED-81 requires the investor's share of the associate's net surplus, net of tax and extraordinary items, to be shown as a single amount as a component of operating surplus before tax. [Separate disclosure would be required of any extraordinary items included in the amount so recognised (see FRS-2/6.9)]. This is a departure from the present practice of recognising dividends received

as a part of operating surplus before tax, and the investor's share of associate's retained earnings after operating surplus after tax.

Accounting for investments in associates

ED-81 has been issued for comment by 31 December 1997. If this exposure draft is approved the new financial reporting standard will replace the paragraphs in SSAP-8 which refer to associates.

Important proposed changes are:

1. Proposed changes to the criteria in identifying an associate:

- the investor must have some level of ownership interest in the investee
- a lack of intention of the investor to hold its investment in the investee as a long-term investment will no longer preclude the investee from being classified as an associate - BUT an investor will not be required to apply the equity method to account for its investment in the associate if the associate "has been acquired and is held exclusively with a view to disposal in the near future".

2. ED-81 clarifies that an associate must not be accounted for on the equity basis in the investor's own financial statements.

- If the investor is required to prepare consolidated financial statements it will account for its investment in an associate in those consolidated financial statements.
- If the investor is not required to prepare consolidated financial statements it will be required to "prepare and present a set of financial statements, in addition to its own financial statements, which apply the equity method to account for an investment in an associate".

3. ED-81 also clarifies that if an investee becomes an associate after one or more previous acquisitions of ownership interests, the carrying amount of the investment is adjusted to that amount "which would have been the carrying amount had it been an associate since the initial acquisition date". The resulting adjustment relating to share of post-acquisition surplus is recognised in the statement of financial performance and the investor's share of post-acquisition movements in reserves is recognised in the statement of movements in equity.

4. ED-81 states that if the recoverable amount of an investment in an associate falls below its carrying amount, the carrying amount must be written down to the recoverable amount. If the recoverable amount subsequently increases, the carrying value will be increased until it reaches the equity value of the investment. Such adjustments are recognised in the statement of financial performance.

- *Recoverable amount is the greater of net realisable value and value in use.*
- *No exception is granted in regard to temporary declines in value.*

5. Whereas SSAP-8 requires goodwill on acquisition of associates to be included with goodwill on consolidation, ED-81 requires goodwill or discount on acquisition to be identified but included in the *investment in associate* item. Goodwill or discount on acquisition will cause adjustments to be made to share of post-acquisition surpluses by way of amortisation of goodwill and adjustments to depreciation charges caused by discount adjustments to asset values.

6. ED-81 requires the investor's share of the associate's net surplus, net of tax and extraordinary items, to be shown as a single amount as a component of operating surplus before tax. [Separate

disclosure would be required of any extraordinary items included in the amount so recognised (see FRS-2/6.9)]. This is a departure from the present practice of recognising dividends received as a part of operating surplus before tax, and the investor's share of associate's retained earnings after operating surplus after tax.

New securities disclosure requirements

The new securities disclosure requirements came into force on 1 October 1997. These requirements were discussed in *Accounting Alert No.2*.

Some of the important changes are:

- The definition of 'securities' has been widened to include interests in superannuation schemes, units in unit trusts and life insurance policies.
 - Information requested by security holders or prospective investors must be supplied within **5 working days**.
 - **Investment statements** are required for almost all securities offered to the public, including equity securities, debt securities, units in unit trusts, interests in superannuation schemes, life insurance policies and participating securities. Investment statements are required **in addition to** registered prospectuses, and may not be incorporated into prospectuses.
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Audit and filing requirements for foreign owned companies

Section 19 of the Financial Reporting Act 1993 (FRA'93) governs the requirements for registration with the Registrar of Companies of financial statements of companies with foreign ownership. Section 196 of the Companies Act 1993 (CA'93) contains the requirement for companies to be audited and allows some exceptions.

In order to determine whether or not a company is required to be audited and/or register its financial statements with the Registrar it is necessary to examine the meaning of 'subsidiary'.

S19 of the FRA'93 requires a company to register its financial statements if:

- a) it is an overseas company; or
- b) it is a subsidiary of a company or body corporate incorporated outside New Zealand; or
- c) 25% or more of the company is held by -
 - i) a subsidiary of a company incorporated outside New Zealand or a subsidiary of that subsidiary
 - ii) a company or body corporate incorporated outside New Zealand
 - iii) a person not ordinarily resident in New Zealand.
- d)

s196 of the CA'93 contains a similar section requiring companies with foreign ownership to be audited except that the corresponding subsection to c)i) only refers to "subsidiary of a company incorporated outside New Zealand".

Meaning of 'subsidiary' under Financial Reporting Act 1993

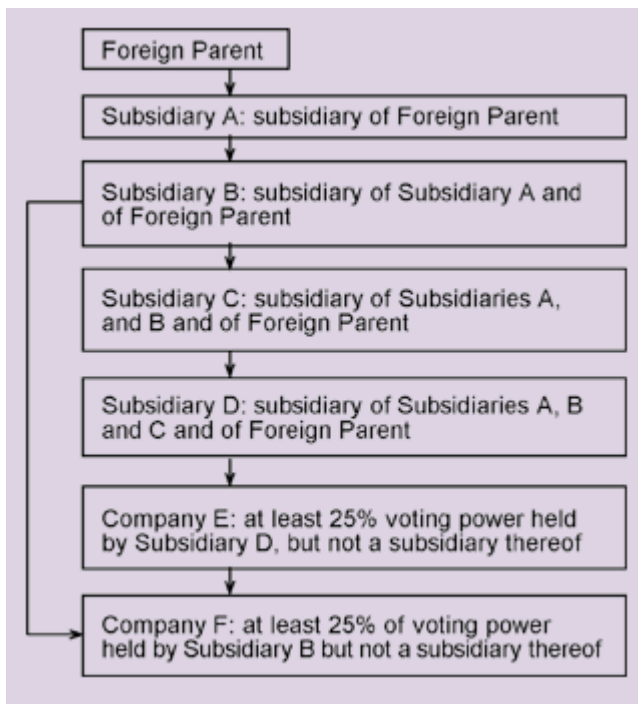
The Financial Reporting Act 1993 [FRA '93] defines a 'subsidiary' by referring to sections 5 to 8 of the Companies Act 1993. Section 5(1)(b) of the Companies Act 1993 [CA '93] states that "the company is a subsidiary of a company that is that other companies subsidiary". Why then does s19(1)(c)(i) refer to a subsidiary of a subsidiary?

The answer is as follows:

When the FRA'93 or the CA'93 refer to a *subsidiary*, the CA'93 definition of a "subsidiary" applies:

- 'Subsidiary' in s19(1)(b) refers to every subsidiary of a subsidiary down to the lowest level of an unbroken chain of parent-subsidiary relationships.
- When the FRA'93 refers to a *subsidiary of a subsidiary* the meaning of each word "subsidiary" is limited to a single reporting entity.
- Section 19(1)(c)(i) in referring to "a subsidiary of that subsidiary", limits the meaning of that phrase to subsidiary at the second level.

In the following table, Foreign Parent is the only company which is incorporated outside New Zealand:



In the foregoing diagram:

- the financial statements of subsidiaries A to D are required to be audited and delivered to the Registrar of Companies for registration per FRA '93 s19(1)(b) and s19(2).
- the financial statements of Company F are required to be audited and delivered to the Registrar of Companies for registration per FRA '93 s19(1)(c)(i).
- the financial statements of Company E do not require registration under s19(1)(c)(i), since it is controlled by Subsidiary D, which is not a subsidiary of a subsidiary of a company incorporated outside New Zealand. However, the shareholders of Company E cannot pass

a unanimous resolution to exempt it from audit [per CA'93 s196(2)], because CA'93 s196(3)(b)(i) refers to a *subsidiary* (the 1994 Companies Act amendment deleted the wording "or a subsidiary of a subsidiary" so prior to that amendment the shareholders of Company E could have unanimously decided against an audit).

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