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SUBMISSION to the INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS BOARD on the IPSASB '*MEASUREMENT*' CONSULTATION PAPER

Dear Sirs,

Introduction

1. This submission is made in my personal capacity.

2. I am a Chartered Accountant (now retired), former Chartered Company Director for private and public entities in New Zealand, former Member of the Wellington City Council Audit & Risk Committee for 11 years, and a 35 year career with the Shell Group of Companies in the United Kingdom, the Far East and in New Zealand.

3. Post-retirement, I received my PhD from the University of Sydney in Business Finance focussed on the (IFRS) Agriculture Standard resulting in support and input to successful representations by South-East Asian Standard Setters to the IASB for amendments to IAS 41 following thesis publication in 2011.

Summary

4. The thrust of the Submission is to consider the sufficiency of the Conceptual Framework ['**CF**'] for General *Purpose* Financial Reporting by Public Sector Entities, occasioned by experience in New Zealand and as a precursor to reflecting on the *'Measurement'* Consultation Paper ['**CP-M'**]).

5. These relate primarily to significant issues in the CF relating, *inter alia*, to the proposal to expense all borrowing costs and the treatment of transaction costs.

6. Separately, and prior to publication of the CP-M, I conducted a Case Study on the application of the IPSAS 5 '*Borrowing Costs*' Standard by all 78 New Zealand Local Government Authorities ['**LGAs**']. The Study highlighted issues with and varied application of IPSAS 5 as recently as the 2017/18 Income Year (although the issues were experienced over at least the previous decade). The Study, plus a subsequent letter from IPSASB member, Mr Todd Beardsworth, replying on behalf of the Controller and Auditor-General, are included for completeness as Attachments to this Submission.

Yours faithfully,

Signed: John Milne
24th September, 2019

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1. Comments on the Conceptual Framework

1. I agree with most of the contents of the CF Preface especially the significance of '*legally mandated, compulsory non-exchange transactions*' (CF p.5, para 8), for service delivery and the differing objectives and roles of the Public vs. Private Sectors.

2. However, I wish, respectfully, to draw attention to the third bullet in para 2 of the CF Introduction: '*Therefore users of GPFRs of public sector entities need information to support assessments of such matters ... as the extent the burden on future-year taxpayers of paying for current services has changed*'. The statement whilst necessary is, in my opinion, insufficient.

3. In New Zealand, public entities are required to respond to NZ IPSAS Standards when preparing their auditable Financial Statements and Long- Term Plans and/or Budgets. These are mandated by legislation (*i.e.* the Local Government Act, 2002) for LGAs and the Public Finance Act 1989 for all Governmental entities, complemented by '*The Treasury Instructions*' issued under Sn. 80 of the latter Act[1].

4. For LGAs there are two governing principles (not always fully followed) for 'Inter-Generational Equity' ['**IGE**']. This has two legs; that, in principle:
   a) requires today's ratepayers to meet the costs of utilising an LGA's assets but does not expect them to meet the full cost of long-term assets that will benefit ratepayers in future generations; also
   b) ratepayers in future generations are not required to meet the present costs of deferred renewals and maintenance[2] [N.B. my emphasis].

5. The CF contains a passing reference to this IGE principle on p.65, para BC 5.39 as relating to '*the revenue and expense-led approach*' as opposed to the alternative '*asset and liability-led approach linked to the notion of changes in resources available to provide services in the future and claims on these resources as a result of period activity*'. Therein lie several issues.

6. First, there are several references throughout the CF about the fundamental differences between the Public vs. Private Sectors to which, generally, IPSAS and IFRS apply respectively; that is, '*the primary objective of most public sector entities is to deliver services to the public, rather than to make profits and generate return on equity to investors*' (*e.g.* CF p.2, para 2; p.4, para 2; *etc.*). In accepting this fundamental difference, IPSAS (and the CP-M) then treat **all** assets as though they are held for their service potential even though some will be and are held for commercial purposes. Is that realistic and/or appropriate? That distinction will be addressed below.

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[1] The latest version is '*Treasury Instructions 2018*' (at //https//treasury.govt.nz/publications/treasury-instructions-2018) due for updating & re-publication in the next month or so for 2019.

[2] Refer to the Attachment "*IPSAS 5 'Borrowing Costs' and Inter-Generational Equity*" for fuller discussion on the Accounting Policy issues under IPSAS 5 in adhering to this principle.

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7. Second, the significance of non-exchange transactions is a defining feature of the Public Sector whereby a public entity resource-provider receives value from service recipients without directly giving equal value in exchange. This may be implemented by legally-mandated, compulsory taxation legislation or mandated rate-raising powers for LGAs. This is complemented by annual Budgets and annual/long-term Plans within a general legislated requirement for 'balanced budgets' covering current and long-term operations and their financing[3]. Therefore, the inclusion of **all** borrowing and transaction costs without further qualification for 'Qualifying Expenditures' transgresses the IGE principle.

8. The effect is summarised in the Auckland City Council's ['**ACC's**] comparative commentary on the '*Main differences between IFRS and PBE (i.e. IPSAS) Accounting Standards*' (refer to Item 3: '*Borrowing Costs*' in Appendix 2 to the Attachment to the letter to the Chief Executive of the External Reporting Board. '*The impact of the difference results from the Group's property, plant and equipment value, and subsequent depreciation expense, being lower than they would be under IFRS. In addition, there is higher interest expense in the period in which qualifying assets are constructed*'. Therefore, current year rating revenues, all other things being equal, are set higher than otherwise needed in order to achieve requisite 'cost recovery'.

9. To extend this funding capability and non-accounting argument to its logical conclusion might suggest the weird proposition to start depreciation 'recovery' whilst a qualifying asset is being constructed, *i.e.* higher depreciation (and borrowing costs) in the current year with lower depreciation (borrowing) charges in future years post qualifying asset completion.

10. Offsetting this effect was a memorandum description, not recorded in the formal presentation of ACC's 2017/18 Financial Report Statements or Notes, referring to capitalisation of certain of cash payments to employees ($40mn.; Group $78mn.) to assets by reclassification from operating to investing activities[4].

11. Third, the CF contains an illuminating and apposite discussion about the Qualitative Characteristics of Relevance; Faithful Representation, including substance over form; Understandability and Comparability (CF Chapter 3). In particular, the comments '*like things must look alike and different things must look different [such that] comparability of information in GPFRs is not enhanced by making unlike things look alike any more than it is by making like things look different*' (CF p.31, para 3.23). This is relevant to the current CP-M discussion and proposals.

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[3] For example, and by way of elaboration, New Zealand LGAs adhere to a Balanced Budget requirement ensuring each year's projected operating revenues are set at a level sufficient to meet that year's projected operating expenses (Local Government Act, Sn. 100; complemented by a Long-term Plan (Sn. 93), an Annual Plan (Sn. 95), a Funding Impact Statement and Funding strategies (Sn. 30) - each expanded in Schedule 10 and all subject to audit by the Auditor-General (or his appointee).

[4] Probably(?) certain internal 'transaction costs' under the IPSAS 17 PP&E Standard. Or, as a cynic might wonder, to reduce the ACC's unbalanced budget to help offset a prospective rate-% increase.

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12. The defining feature of Public Sector assets comprises assets with service potential for service delivery objectives to the public (a unique feature for IPSAS reporting) plus other assets of a more 'commercial' nature for which traditional IFRS definitions and rules should apply (*e.g.* a commercial parking building, toll road or participation in a public-private partnership, *etc.*) – but are not proposed for differentiation. The CF and CP-M treat these essentially different types of assets as the same when employed by a public sector entity - even if their character may change through time. For example, an operational work-in-progress asset is different from a completed asset – and indeed different accounting rules apply – although the IPSASB Diagram 4.1 decision-making Flow Chart appears not to recognise that possibility.

2. Borrowing Costs

1. Likewise, for Borrowing cost 'Qualifying expenditures'. This is a clearly defined IFRS term and concept dictating the capitalisation of associated borrowing costs during a construction pre-operational phase[5]. Under current IPSAS 5 accounting rules, and in practice, this is an optional treatment to recognise borrowing cost capitalisation, or not. For Governmental entities and the majority of LGAs the latter applies[6]. This is now the proposed treatment in the CP-M whether or not discrete borrowings are arranged to fund a specific qualifying asset. Therefore, there is a disconnect between expectations arising from general IFRS rules. In short, '*making like things look different*'.

2. This suggests that a blanket treatment of non-capitalisation of all borrowing costs is inappropriate. Rather, the distinction should be made when finalising the CP-M between 'service potential' assets; for which the CP-M proposal could apply (i.e. the Benchmark Treatment in IPSAS 5); whereas for IFRS-type 'commercial' assets, **or** in those circumstances where dedicated borrowing occurs for financing any 'service potential qualifying asset' these should require IAS 23 customary treatment; that is, without the ambiguous anomaly inherent in the IPSAS 5.15 'Benchmark Treatment' definition effectively, in practice, disqualifying use of the 'Allowed Alternative Treatment'.

3. If the proposal proceeds, there will need to be prompt consequential amendments to existing Standards (and parts of the Conceptual Framework?) - for example, and randomly, the specific reference in IPSAS 5 and IPSAS 17.36, and there are many others. This should occur prior to or simultaneously with the outcome of this CP-M process so as to avoid uncertainty (or gaming) over application of IPSAS Standards.

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[5] N.B. Also, the Qualifying asset definition in each of IAS 23.5 and IPSAS 5.5 contains the phrase '*that necessarily takes a substantial period of time to get ready for its intended use* ... '. Since the period is not clearly defined local respondents have used this as a justification not capitalising borrowing costs.

[6] The *2018 Treasury Notes* p.21. Para 3.5.9.2 state for 'Capitalisation of borrowing *costs* ' *Generally, Government borrowings are not directly attributable to individual assets. Therefore, borrowing costs incurred during the period, including any that could be allocated as a cost [of?] completing and preparing assets for their intended use are expensed rather than capitalised*'. For LGAs refer to the 'IPSAS 5 'Borrowing Costs' and Inter-Generational Equity' Study attachment.

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C. Transaction Costs

1. Arguably (and in reality) Qualifying asset borrowing costs pre-completion are an integral transaction cost covered by the proposed definition (CP-M p.28, para 3.36):
   'Incremental costs that are directly attributable to the acquisition, issue or disposal of an asset or liability and would not have been incurred if the entity had not acquired, issued, or disposed of the asset or liability
   especially for 'commercial' type assets where there is equivalence to internal costs (refer the ACC case above), professional fees and especially transportation costs for an asset to reach the final location for the asset to be capable of operating.

2. It is easy to acknowledge the Option 1 preference (Paras 3.39-42) is an ambitious objective. Consideration may need to be given however for the special characteristics of financial assets and liabilities vs. operational assets and liabilities. As a sub-set of the latter, it is recommended consideration be given anyway to service potential vs. 'commercial' assets (and liabilities) for reasons outlined above. As an extension to this should be a strong preference for comparability between expectations of equivalent usage between major IPSAS and IFRS elements and their definitions – such that '*like things must look alike and different things must look different*' (CF para 3.23);

3. Matters not addressed

1. Sadly, it is a fact of life that the Public Sector is increasingly suffering from all kinds of natural disasters with considerable financial and accounting reporting significance and consequences for them – for example: the Christchurch and Kaikoura earthquakes (refer some of the consequences contained in the attached Study), the Fukushima tsunami, tornados, floods, eruptions....and other potential climate emergency events. These inevitably involve accounting recognition, revaluation and impairment (plus funding) issues for any destroyed or badly damaged public assets, repairing such impaired assets and the appropriate treatment of expected or actual insurance proceeds occurring over subsequent period/s. I recommend common application rules and accounting treatments be considered and promulgated within the proposed final Measurement Standard.

2. As possible guidance to and consideration by the IPSASB, New Zealand's '*Treasury Instructions 2018*' provides for these eventualities – refer pps. 35-36, paras 4.3.3 '*Losses arising from natural disasters*' and application of '*Insurance proceeds*' (para 4.3.2.1) in such circumstances.

3. Given the CF-M discussion is confined to physical assets, consideration ought also be given to the measurement treatment of certain *Intangible Assets* such as Computer Software and developments where their ubiquity is a special feature of Public Service operations and for which global common measurement definitions, processes and accounting treatment should be specified. Again, the treatment in New Zealand's *Treasury Instructions* on pps. 39-40 deserves consideration as part of the Measurement Standard consideration to ensure '*like things look alike*'.

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E. Attachments

The Attachments to this Submission are in PDF format and comprise:

1. Letter dated 24th January, 2019, entitled '*IPSAS 5 Borrowing Costs & Inter-Generational Equity*' to Mr Warren Allen, Chief Executive, External Reporting Board with Attachments[7] [25 pages]:
    a. '*Main differences between IFRS and PBE Accounting Standards*' (extracted from the Auckland City Council 2017/18 Financial Report), and
    b. the WCC Finance, Audit & Risk Management sub-Committee Meeting letter dated 6th March, 2018, to Mr Kevin Lavery, CEO Wellington City Council (which triggered the whole IPSAS 5 Case Study letter to Mr Warren Allen).

2. Letter dated 24th January, 2019 entitled '*IPSAS 5 Borrowing Costs & Inter-Generational Equity*' to Mr John Ryan, Controller and Auditor-General and the reply on his behalf by Mr Todd Beardsworth, dated 5th April, 2019 [4 pages].

F. Requested Summary Comments on Preliminary Views (PV)

PV.7 – No. Refer Item B. above, with the recommendation that borrowing costs arising from qualifying assets pre-completion should be distinguished between service potential (therefore IPSAS – except for dedicated borrowings) and commercial attributes (therefore IFRS) rather all be lumped together conceptually, and therefore practically) as equivalent assets under IPSAS.

PV.8 -Yes.

PV.9 – Not necessarily. Refer C.2 above.

Specific Matter 1 – No, not sufficient. Recommend consideration also be given to what may loosely be termed as natural events and/or climate emergency damage, impairment and restoration (plus consequential multi-period Insurance proceeds); and, rather than focus solely on physical assets, consider including measurement and revaluation policies attributable to Intangible assets *e.g.* Computer software.

Specific Matter 2 – Recommend primary focus onto the better-known and more commonly understood IFRS definitions and policies so as to maximise CF and Measurement IPSAS consistency and decision-making objectives (such that *like things must look alike and different things must look different*) wherever possible, rather than further complicate with new or different definitions and practices associated with IVS and GFS, unless really necessary.

[7] I am advised this Study was forwarded to the IPSASB in Toronto but have no supporting information.

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24th January, 2019.

IPSAS 5 'Borrowing Costs' & Inter-Generational Equity

Mr Warren Allen,
Chief Executive, External Reporting Board,
Wellington.

By E-mail

Dear Warren,

I have been critical about the lack of capitalisation of interest on 'qualifying expenditures' under the *IPSAS 5* 'Borrowing Costs' standard (and its predecessor/s) by the Wellington City Council (WCC) for a number of years for a number of reasons – each of which is expanded, as requested, in the Itemised Attachment:

1. Conflict with statutory responsibility of Tier-1 (and 2) Local Authority reporting entities relating to adherence to the inter-generational equity principle;
2. Optionality provisions in *IPSAS 5* compared to *NZ IAS 23*;
3. Variable financial reporting and auditing practice in New Zealand;
4. Actual and potential consequences for Rate-setting and possible audit solution;
5. Apparent justifications for prevailing local authority policy practice;
6. Conclusions; and
7. Recommendations for consideration by the XRB, the IPSASB and the Auditor-General.

Background to current research on this issue:

This research derives from my own studies into the WCC reporting entities and, latterly, to the whole Sector with the invaluable assistance of the NZ Taxpayers' Union.

My initial concern was expressed to the WCC Audit & Risk Management sub-Committee in 2010[1] as a potential audit and reputational risk issue. When I received the draft template for the WCC's 2017-18 Financial Statements I saw no change had occurred since my initial August 2010 recommendation to adopt interest capitalisation in relevant circumstances. Accordingly, I attended the WCC's Finance, Audit & Risk Management [FARMs] meeting last March to raise the issue again. Appendix 3 contains the original meeting request letter and rationale for this research.

Since then, I sought assistance from the NZ Taxpayers' Union to conduct a LGOIMA request to all Local Authorities to determine whether this was a unique WCC situation or reflected a wider issue around the country (Item 3 below) with consequences for Rate-setting (Item 4).

The importance of the role of Auditors in obtaining a consistent solution and principled outcome is a significant finding. Given the relevance of these findings and recommendations, this letter is also forwarded to the Auditor-General for his information and consideration. A hard copy follows.

Kind regards,
Dr John Milne

~~[for]~~ Mr Jordan Williams,
Executive Director, The New Zealand Taxpayers' Union
PO Box 10-518, The Terrace, Wellington

[1] Declaration of Interest: I was an Independent Member of the sub-Committee from 1997-2010

ATTACHMENT

1 Purpose of International Public Sector Accounting Standards (IPSAS)

The then Controller & Auditor General (Lyn Provost, 'the AG')[2] described the relevance and importance of differentiating IPSAS (for the Public Sector, including Local Authorities) from IFRS (for the Private Sector and for 'profit-oriented' entities) as contained in her 32 page Report to The House of Representatives in February 2016 entitled '*Improving Financial Reporting in the Public Sector*'.

This traces the evolution and framework of reporting Accounting Standards between the two Sectors. '*The new [Public Sector] Framework is designed so that financial reports will better meet the needs of users...for both public benefit entities* [PBEs] *and those for commercially focussed entities both of which are applicable to the public sector*' [p.4]. The associated legislative changes developed under the External Reporting Board [XRB] *are designed to make financial reporting by public entities* ***more useful and more relevant****, with a view to improving accountability and decision-making*' [p.4]. By so doing, '*public entities need to take advantage of the flexibility available within the new* (IPSAS) *Accounting Standards framework by* ***focussing on users' information needs and what matters most***' [p.4] (**emphasis added**).

In advocating new IPSAS standards relevant to the public sector, she believed '*this would result in reporting that could be used for decision-making and to properly hold public entities to account*' [para 2.21]. In general, she considered '*the PBE accounting standards provide a good platform for future financial reporting by public benefit entities in the public sector*' [para 4.17].

The thrust of this submission is that Users' information needs and what matters most include, for Ratepayers, understanding of and satisfaction that annual rates charged, and paid, are soundly based in terms of those Accounting Standards (and statutory requirements); capable of determination transparently and consistently across the Sector, and applied consistently between Local Authorities; all subject to consistent audit assurance – in this case by the AG, and Auditors appointed by him - that '*the information a public entity reports materially complies with those accounting standards and fairly* presents *the performance of the entity for the period that the financial report covers*' [para 1.21]'.

This submission contends that, unfortunately, this is not the case for the accounting treatment of 'borrowing costs' under IPSAS 5 – such that, the financial statements across Local Authorities – but in particular the Tier 1 City Councils – are inconsistent because the accounting treatment of borrowing costs does not always follow the IPSAS 5 accounting principles and these inconsistencies are apparently acquiesced by auditors.

Before developing this further, there is a major difference to note between financial reporting and standards for PBEs in Australia. In principle, both countries have sought to align their accounting standards onto a common harmonised basis. This applies for the '*for profit sector*' under IFRS '*to help build a more competitive and productive economy*' [para 3.16] *e.g.* for stock market listings.

Thus, as you are aware, City Councils in Australia currently report under IFRS, whereas those in New Zealand adopt IPSAS[3] for Tier 1 (or 2) reporting entities.

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[2] Now John Ryan; approved by Parliament in April 2018.

[3] However, with the recent changes foreshadowed in the IFRS framework it becomes possible the two may converge onto IPSAS.

2.1 Inter-Generational Equity

The principal objective of WCC's *Equity Management* is maintained, as for the last decade, in the WCC's 2017/18 Financial Statements (refer p.211):

> *'The Local Government Act 2002 ('the Act', 'the LGA')* ***requires*** *the Council to manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes the* ***current and future interests of the community****. Ratepayer funds are largely managed as a by-product of managing revenues, expenses, assets, liabilities, investments, and general financial dealings* **[emphasis added]**.
>
> ***'The objective of managing these items is to achieve intergenerational equity, which is a principle promoted by the Act and applied by the Council. Intergenerational equity requires today's ratepayers to meet the costs of utilising the Council's assets but does not expect them to meet the full cost of long term assets that will benefit ratepayers in future generations.*** *Additionally, the Council has* ***asset management plans*** *in place for major classes of assets, detailed renewal and programmed maintenance...****These plans ensure ratepayers in future generations are not required to meet the costs of deferred renewals and maintenance.***

As another example, The Christchurch City Council describes the inter-generational equity principle similarly, but adds:

> '*The Act requires the Council to make adequate and effective provision on its LTP* [Long Term Plan] *and in its Annual Plan (where applicable) to meet the expenditure needs identified in those plans. The Act also sets out factors that the Council is required to consider when determining the most appropriate sources of funding for each of its activities. The sources and level of funding are set out in the funding and financial policies of the LTP,* (CCC 2017/18 Financial Statement Notes, para. 31 'Capital Management', p.212).

The Act also requires the Long Term and, where appropriate, the Annual Plan be audited. The Auditor is the AG (LGA.70) or an Auditor appointed by him – usually Audit New Zealand.

These inter-generational equity principles described, *e.g.* for 'borrowing costs', are consistent with their obverse whereby, for example, the WCC's Accounting Policy for '*Depreciation*' (Note 8, p.170) reflects that whilst an asset is incomplete and unable to contribute resources or save expenses there is no depreciation charge in a current year, nor until such time as it is ready-for-use. Just as, where these occur, current year costs for deferred renewals and maintenance are not 'capitalised' to be met by future ratepayers (see above).

Moreover, the Auckland Council (AC) in its 'Basis of reporting' (2017/18 Annual Report, Vol 3, p.12) notes (by way only of a memorandum note) that certain cash payments to employees (Council 2018: $40mn, Group $78mn) were capitalised to assets by reclassification from operating to investing activities. There is no other reference, elaboration or reconciliation in AC's Financial Statements. Nor was any other equivalent example observed for other City Councils.

Before considering the implications of the inter–generational equity principle it is appropriate to consider how *IPSAS 5* (for New Zealand Local Authorities) and *AASB 123*[4] (for Australian Local Authorities) defines the accounting treatment of 'borrowing costs' under respective generally accepted accounting practice [GAAP] rules.

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[4] Equivalent to IFRS IAS 23 and NZ IAS 23 'Borrowing Costs'

2.2 Optionality in *IPSAS 5* vs *NZ IAS 23* on Treatment of 'Borrowing Costs'

2.2.1 Definitions under *IPSAS 5*

'**Borrowing costs** are *interest and other expenses incurred by an entity in connection with the borrowing of funds*';
'Qualifying asset' is *an asset that necessarily takes a substantial period of time to get ready for its intended use or sale'* (*IPSAS 5.5).*

'The **'Borrowing Costs - Benchmark Treatment'** (*IPSAS 5.14)* states:

> *'Borrowing Costs shall be recognised in the period in which they are incurred'. IPSAS 5.15* states *'Under the benchmark treatment, borrowing costs are recognised as an expense in the period in which they are incurred, regardless of how the borrowings are applied'.* And, *IPSAS 5.16* requires *'disclosure of the accounting policy be adopted for borrowing costs.'*

In the case of the WCC, Note 6 '*Finance Expense*' states '*All Borrowing Costs are expensed in the period in which they are incurred' (p.167)'.* [*N.B.* Refer to Item 3 below for the relevant accounting policy for all other Local Authorities].

Equally valid, especially where major 'qualifying expenditures' in scale, type of assets and significance or materiality are concerned is the *IPSAS 5.17* **'Borrowing Costs - Allowed Alternative Treatment'** whereby:

> *'Borrowing costs* ***shall*** *be recognised as an expense in the period they are incurred,* ***except to the extent they are capitalised and in accordance with IPSAS 5:18*** (which states) '***Borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying assets shall be capitalised as part of the cost of that asset'*** **[emphasis added].**

IPSAS 5.19 adds that *under this treatment, such borrowing costs are capitalised as part of the cost of the asset when*

a. *it is probable that they will result in future economic benefits or service potential, and*
b. *the costs can be measured reliably.*

Other borrowing costs are recognised as an expense in the period in which they are incurred.

However, *IPSAS 5.20* goes on to state 'where an entity **adopts the allowed alternative treatment**, that treatment shall be applied consistently to all borrowing costs that are directly attributable to the acquisition, construction, or production of all qualifying assets of the entity' [**emphasis added**].

In other words, in practice, if a Local Authority chooses preferentially to adopt the 'Benchmark Treatment' then it appears that no borrowing costs relating to qualifying assets are capitalised. It is doubtful this practice is what the Standard Setters intended. By contrast, NZ IAS 23 has no such optional exclusion for capitalising borrowing costs on qualifying expenditures.

In the case of the WCC, their '*Property, Plant & Equipment*' Note 18 states the current Policy is *'Borrowing costs incurred during the construction of property, plant and equipment are not capitalised'* (p.185) without any further qualification. Thus, the accounting treatment currently adopted by the WCC appears to be at odds with its stated over-riding principle of adhering to inter-generational equity specified under its *Equity Management* objective.

2.2.2 Definitions under *NZ IAS 23 for For-Profit entities*

'***Borrowing* costs are interest and other costs that an entity incurs in connection with the borrowing of funds'**;

'**A *qualifying asset* is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale'** (*IAS 23.5*).

Under *NZ IAS 23*, the **'Core Principle'** is that:

> *'**Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense**'.*

For recognition *IAS 23.8* identifies that**:**

> ***'An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them'.***

IAS 23.10 adds 'The *borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.*

To all intents and purposes, the definitions in each Standard are the same – apart from the recognition policy linkage between expensed and capitalised borrowing costs. Thus, there appears to be no good reason why the GAAP capitalisation principles in NZ IAS 23 should not also apply to IPSAS 5 accounting capitalisation principles for consistency reasons to avoid any ambiguity or optionality anomaly.

It should be noted here that current IASB Member, Professor Ann Tarca identified that the IASB sought to remove all optionality from their IFRS suite of Standards during the 2001-3 period when she surveyed the IASB's development of IFRS from 2001 during her October 2018 Chambers Memorial Lecture at The University of Sydney.

Thus New Zealand Local Authority responders to *IPSAS 5*, unlike those in Australia utilising AASB 123, have optionality[5] whether to identify and reflect the consequences of borrowing for 'qualifying expenditures' in their financial statements - or simply to ignore them. And, that is what occurs, with only a few exceptions.

This study will demonstrate that actual practice on applying the *IPSAS 5.17+18* capitalisation principle is very varied across the sector – refer Item 3 below with the apparent acquiescence of the Office of the Auditor General.

[5] Per IPSAS 5.20, further confirmed in Appendix 2, p.20 below, for the Auckland Council.

2.3 Borrowing Costs eligible for capitalisation

2.3.1 The capitalisation requirements in ***NZ IAS 23*** are contained in clauses *23.10-15.* Cl. *23.12* covers (net) borrowings for an eligible specific qualifying asset for which capitalisation is appropriate; or, where funds are used from general borrowings, the capitalisation rate shall be a weighted average of the borrowing costs to all borrowings of the entity that are outstanding during the period (excluding any specific borrowings, nor exceeding the total amount of total borrowings) until such time as the (qualifying) asset is ready for use (23.*14*).

Moreover, in some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs. In other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings *(23.15).* It is a matter of judgment.

These principles are well understood for the *For-Profit* sector entities, and by their Auditors. Indeed, in the case of the WCC, its 34% holding in Wellington International Airport Limited (managed by Infratil Limited) applies this interest capitalisation principle in respect of the new hotel/parking building complex 'qualifying expenditures' now under construction at the airport. However, unlike for the Dunedin City Council, such different treatment is not adjusted by the WCC when preparing its consolidated Group financial statements to conform to the WCC's own current formal 'non-capitalisation' borrowing costs Accounting Policy.

2.3.2 On the other hand, the requirements of ***IPSAS 5.21-29*** are more varied and open to interpretation and/or provide differences in practice. These are couched in terms of borrowing costs that would have been avoided if outlays on a qualifying asset had not been made (*5.21*). Identification of the direct relationship of borrowings to qualifying expenditures may be difficult where, for example, financing is coordinated centrally, where there is a range of differing debt instruments, where there are capital grants, or low/no inter-entity interest advances made to controlled entities within the entity group (*5.22*).
However, it should be noted that all these possibilities are quite standard practice for the *For-Profit* sector and applied satisfactorily under ***NZ IAS 23.11*** for consolidated group entities, when subject to audit.

2.3.3 *IPSAS 5.*26-27 covers a range of interest capitalisation treatments (or lack of them) for inter-entity advances relating to qualifying asset expenditures between a controlling and controlled entities and which entity **may** account for what, individually or whether or where consolidated, or not at all.
These ambiguities, complexity and lack of clear 'rules' (unlike in *NZ IAS 23*) probably accounts for the findings in Item 3 below. That is, that virtually all Local Authority entities in New Zealand fail to recognise the GAAP definitional principles relating to 'qualifying expenditures' under *IPSAS 5.5*, and therefore, when adopting the *IPSAS 5.14* 'Benchmark Treatment', any interest on borrowings which finance 'qualifying expenditures' are not capitalised at all.

This has direct consequences contrary to the inter-generational equity principle and for Local Authority rate-setting responsibilities. These are covered in Item 4 below.

3 Variable Local Authority financial reporting (and auditing) practice in New Zealand

The Taxpayers' Union sent out a LGOIMA request last October to all Local Bodies *i.e.* Regional, Local and District Authorities. The table below summarises the replies. It also identifies the Auditor entities appointed by the Auditor-General (AG).

TABLE 1 - Local Authority Auditors, Borrowing Costs Accounting Policy per IPSAS 5,

Auditor	AG or Audit NZ		Deloitte or EY		Total
IPSAS 5.14 Benchmark 5.17 Alternative	**Expensed**	**Capitalised**	**Expensed**	**Capitalised**	
City Councils	12	1	-	1	14
District Councils	42	-	10	1	53
Regional Councils	7	-	1	3	11
Total	**61**	**1**	**11**	**5**	**78**

Source: LGOIMA Requests and Annual Reports - 2017/18 Financial Statements

Our findings are that only six Local Authority Councils have adopted the *IPSAS 5.17 'Allowed Alternative Benchmark* (interest capitalisation) *Treatment*'. They comprise the Dunedin and Porirua City Councils, the Gisborne District Council and the Otago, Southland and Taranaki Regional Councils respectively (refer Table 2 on p.9 for the full City Councils' list and Table 3 in Appendix 1 for all District and Regional Councils).

The AG and Audit New Zealand (on behalf of the AG) audits 62 of the total 78 Local Authorities. All, adopt the '*Benchmark Treatment*' non-capitalisation option (IPSAS 5.14) except one – the Dunedin City Council. Those **not** audited by Audit New Zealand are subject to AG out-sourced term contracts conducted by either Deloitte or EY. Five of these 16 auditees adopt the capitalisation '*Alternative Benchmark Treatment*' (IPSAS 5.17).

The fourteen City Councils reported interest expenses totalling $579 million in 2017/18 (2016/17: $545mn). In the same periods, the reported annual City Councils Work-in-Progress figures were $1.52 billion for 2017/18 (2016/17: $1.18 billion) for expenditures extending beyond the 30th June financial year – refer Table 2 below.

Effectively, twelve City Councils are taking advantage of *IPSAS 5.20* optionality without the necessity of determining whether asset expenditures meet the '*Qualifying Expenditure*' definitional criteria for interest capitalisation. Taken together, it is extraordinary that the predominance of the '*Benchmark Treatment*' for borrowing costs prevails when there are now so many potentially '*qualifying expenditure*' capital projects underway, or in prospect, across the Sector.

Indeed, mid last year the WCC amended its Long Term Plan (LTP) Policy statement by extending their Liability Management period from a rolling 12 months forecast period, adopted hitherto, to a ten year horizon. This was because '***with significant capital investments [due] throughout the LTP period, debt is forecasted to go up...***(LTP, p.168)....***with increasing debt levels over the 2018/28 Long-Term Plan period'.***

A further recent example was reported in the Dominion Post (pp. 1-2 on 13th November) for the building strengthening and renovations plus seismic up-grading of the St James Theatre with costs rising from an initial LTP budget of $17mn to a revised $33mn. Theatre reopening is scheduled for September 2020. There must be a *prima facie* case for this project to constitute qualifying expenditure. However, Councillor Young was reported as stating[6] *"the increased costs wouldn't impact ratepayers significantly. The project was capital expenditure so the money would be borrowed, spreading the cost burden over 50 years".* This, of course, refers to the annual Depreciation expense; but **not** to the related project borrowing costs under the WCC's current 'borrowing costs' Accounting Policy, whereby the $2-3mn in interest costs pre-completion would be charged to current ratepayers when determining the council's annual rates levy basis within its balanced operating budget requirement.

In short, the WCC would not be adhering fully to its inter-generational equity objective; nor to the *IPSAS 5.17* Standard requirement, since whilst the newly built St James Theatre asset (as defined in IPSAS 5.5) is under construction, prior to use, etc. and is financed specifically by and/or is incurring general borrowing costs (as the WCC's LTP outlines) *'to meet additional demand', to improve the level of service'* and even *'to replace (some) existing assets.* As a result, those borrowing costs on such work-in-progress should in principle be capitalised under inter-generational equity (but possibly subject to relevant materiality) to the individual asset/s concerned until such time they are 'ready for use'.

Other recent media reported examples include the Auckland Council's $113mn (current) forecast for the Americas Cup Village development in the Wynyard precinct and the Wellington City Council's potential $2.2mn funding for the $4.2mn Sports Hub at the Alex Moore Park in the Northern Suburbs.

The conclusion must be that the AG and Audit NZ **A**uditors (including Auditors contracted to the OAG) are acquiescing in exclusively allowing the expensing optionality afforded to the 'Benchmark Treatment' *(IPSAS 5.14*), rather than the definitional 'qualifying expenditure' criteria envisaged in *IPSAS 5.5.* This is developed further in Item 4 below.

Whilst there are recognised differences between the *For-Profit* and *Public Benefit Entity* Sectors – as set out comprehensively in the AG's February 2016 Report *"Improving Financial Reporting in the Public Sector"* - there is no reference to the consequences for appropriate financial reporting for consistency for rate- (or tax-) setting responsibilities for the Public Sector, nor to the general inter-generational equity principle established by Parliament to the LGA.

This has consequences for Local Authority rate-setting activities and their annual reporting of Net Surpluses/Deficits (Item 4 below).

[6] After being briefed by the WCC CFO.

TABLE 2

CITY COUNCILS – Their Auditors, Borrowing Costs Accounting Policy per IPSAS 5, Annual Current Works-in-Progress and Annual Interest Costs

City Council	Auditor	Interest Expensed/ Capitalised	WIP # 2018	WIP # 2017	Interest 2018	Interest 2017
			$ 000s	$ 000s	$ 000s	$ 000s
Auckland ##	AG	Expensed	432,000	399,000	391,000	364,000
Christchurch ø	Audit NZ	Expensed	407,615	336,818	89,342	82,072
Dunedin	**Audit NZ**	**Capitalised**	15,947	20,177	11,900	13,075
Hamilton	Audit NZ	Expensed	71,485	71,706	10,835	10,772
Hutt	Audit NZ	Expensed	45,534	25,937	6,767	5,857
Invercargill	Audit NZ	Expensed	7,473	2,668	2,869	2,738
Napier	Audit NZ	Expensed	17,111	17,404	1,539	1,295
Nelson	Audit NZ	Expensed	16,468	7,720	4,320	4,217
Palmerston North	Audit NZ	Expensed	32,938	21,001	5,846	6,223
Porirua	**EY**	**Capitalised**	36,123	15,953	3,529	3,284
Rotorua Lakes	Audit NZ	Expensed	39,702	23,250	7,618	7,008
Tauranga	Audit NZ	Expensed	191,550	125,186	19,159	18,920
Upper Hutt	Audit NZ	Expensed	6,501	7,709	1,468	1,674
Wellington	Audit NZ	Expensed	197,693	106,482	23,062	22,958
Total			1522,140	1181,011	579,254	545,003

Source: 2018 Annual Reports – City Council Audited 2017/18 Financial Statements

- # Annual Work-in-Progress at 30th June.
- ## By contrast, the Auckland Council reported it had capitalised certain other cash payments to employees within operating expenditures by reclassification to investing activities to better align the nature of the underlying cash flows: *i.e.* $40mn in 2018 (Group: $78mn), Vol 3, p.12.
- Ø Following the aftermath of all the December 2013 earthquake sequences the Christchurch City Council (CCC) commissioned two major independent advisory Financial Reports by:
  - **KordaMentha** to undertake an assessment of the financial estimates and assumptions underpinning the city's three year Plan adopted in June 2013; and
  - **Cameron Partners** in 2014 to look at the performance of Christchurch City Holdings Ltd and Council-owned trading organisations. The scope of the resulting report was widened to consider all capital and operational expenditure by the Council with the aim of providing residents with a full picture of the Council's financial position, and options for dealing with it.

  More specifically, these were to consider funding and rating options to ameliorate the CCC's increased required capital expenditure renewal programmes, resulting increased debt liabilities, funding covenant restrictions and financing requirements and associated rating consequences.

  Neither Report considered the implications of the CCC's current borrowing cost 'expensing' (*IPSAS 14*) Accounting Policy [vs. interest 'capitalisation' per *IPSAS 17*] to help alleviate financial reporting and rating pressures, nor associated inter-generational equity principles.

4. Actual and potential consequences for Rate-setting and for 'over-charging' current ratepayers

4.1 - General principles and consequences

The underlying principle of the LGA rate-setting mechanism under the Long Term Plan (LTP) is that Local Authorities are to maintain (on average and over time) a balanced net surplus/deficit after covering all planned operating expenditures, including depreciation and interest.

The Act specifies Local Authorities prepare an LTP (LGA. 93) that:

- for each year covers up to 10 consecutive financial years ahead[7];
- sets out the rating criteria and rules to apply including for budgets and financial planning;
- per Schedule 10, requires the accounting policies and assumptions, forecast annual income statements, balance sheets and sources & disposition of funds, forecast capital expenditure for groups of activities, and a comprehensive Funding Impact Statement (LGA. 30) prior to the start of the financial year (and following consultation with ratepayers);
- must be audited (LGA.93, 94, 99); and
- The Auditor-General (AG) is auditor of all council-controlled organisations (LGA.70).

The AG (or his appointed Auditor) has significant statutory responsibilities and opportunities for achieving consistency of reporting and practice across the Sector – not only for financial reports but also, most unusually, for future financial plans. In practice this is not as consistently applied as might be expected and, perhaps, as Parliament probably intended, especially consequential on the inter-generational equity principle and as it relates specifically to borrowing costs.

As a consequence, Audit and Auditors are an integral part of a principled process and solution.

Thus. when setting an annual rate levy, **current** Ratepayers are (by 'Benchmark Treatment' accounting policy definition, which pre-dominates) being charged on a cash spent or accrued basis in the annual budgeted rate-calculations for non-capitalised borrowing costs on work-in-progress qualifying capital expenditures which, by definition, will benefit future ratepayers. Non-capitalised interest should instead be recovered from future rate payers via the annual depreciation charge on the enhanced asset value under the inter-generational equity principle.

For most Local Authorities, virtually all current ratepayers are being **over**-charged, to a greater or lesser extent, in current rating levy calculations and rating levy-% increases. The inter-generational equity statutory principle is not being upheld, notwithstanding, for example, the WCC claims to do so in its '*Equity Management*' objective. Likewise, for most other Local Authorities.

Alternatively, the result is the underlying budgeted (or actual) Surplus on Operations is **under**-stated for a current year because the Rates expenditure recovery levy calculation is **over**-stated via an interest non-capitalisation policy; or, alternatively, rating-% increases are higher than they should be. Magnified over the whole country this would result in significant over-rating by Local Authorities, especially those undertaking new major capital projects – as is occurring; and, this at a time when interest rates are at historically relatively low levels – but forecast to increase in future years.

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[7] An exception has occurred for the Kaikoura District Council, post-the November 2016 earthquake, for a three-year unaudited plan until June 2021. Refer also to the discussion in Item 4.3, p12 below.

4.2 - Accounting Policies on Borrowing Costs

As noted previously, and recorded in the Tables in Item 3 above, Accounting Policy statements for 'Borrowing Costs' are not consistently applied across all Local Authorities depending on whether they adhere to whichever of the *IPSAS 5.14* or *IPSAS 5.17* options.

4.2.1 - Benchmark Treatment

The predominant basis is to expense all borrowing costs under *IPSAS 5.14*. The policy is expressed basically as-

> *"Finance costs comprise interest payable on borrowings calculated using the effective interest rate method. Interest payable on borrowings is recognised as an expense in surplus or deficit as it accrues"* (Christchurch City Council 2017/18 Annual Report)

The 'expensiing' option narration is derived from the Audit NZ 'Model Financial Statements' template for "Te Motu District Council 2016/17". This was issued by their Executive Director in June 2017. The supporting narration notes *'[t]hese model financial statements have been developed for local authorities that use the public benefit entity (PBE) accounting requirements for Tier 1 and Tier 2 entities...The 2017 update to the model financial statements for local authorities* ***focuses on improving the presentation and disclosure of the financial statements to improve communication to readers [*emphasis added**]'.
The recommended Audit NZ Accounting Policy template Note reads: ***Finance costs per PBE IPSAS 5.17***[8][9]***:*** *'Borrowing costs are recognised as an expense in the financial year in which they are incurred.*

4.2.2 - Allowed Alternative Treatment

Representative examples of the IPSAS 5.17 accounting policy narration are as follows:

Dunedin City Council [Audit NZ]

Borrowing costs are usually recognised as an expense in the period in which they are incurred.

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale.

Porirua City Council [EY]

Borrowing costs are recognised as an expense when incurred, except borrowing cost directly attributable to the construction of a qualifying asset which are capitalised as part of the cost of that asset.

Gisborne District Council [EY]

Borrowing costs (except borrowing costs incurred as a result of capital work) are recognised as an expense in the period in which they are incurred. When the construction of assets are [sic] loan funded, all borrowing costs incurred as a result of the capital work are capitalised as part of the total cost of the asset up until the point where the asset enters service.

Southland Regional Council [Deloitte]

Borrowings are recorded initially at fair value, net of transaction costs. Borrowing costs attributable to qualifying assets are capitalised as part of the cost of those assets.

Taranaki Regional Council [Deloitte]

All borrowing costs are expensed in the period they occur, except to the extent the borrowing costs are directly attributable to the acquisition, construction, or production of qualifying assets. These shall be capitalised as part of the cost of the asset. Borrowing costs consist of interest and other costs that an entity incurs in connection with the borrowing of funds.

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[8] The template refers erroneously to IPSAS 5.17 (being the capitalisation – 'Allowed Alternative Treatment'), whereas the Model's recommended narration Policy Statement actually relates to the IPSAS 5.14; the expensing 'Benchmark Treatment'...!

4.3 - Unintended Accounting Policy Consequences for Earthquake-hit Local Authorities.

From Table 2, the earthquake-hit Christchurch and Wellington cities have some of the highest work-in-progress, interest and (rising) debt levels in the country. However for the Tier 2 earthquake-struck Kaikoura District Council the problem was so dire that Parliament was obliged to pass a special Act to waive most LGA requirements *(e.g.* the audited LTP and Annual Financial Statements)[10].

In these circumstances the *IPSAS 5.17* Standard should be mandatory given the exceptional rebuilding of essential infrastructural water, waste-water, roads and other significant community assets. In the case of Kaikoura, for instance, the increased rateable levy (including borrowing costs) have basically doubled, even quadrupled for some. Capital expenditures have increased from approx. $3mn in the 2017/18 LTP to $19.95mn in the first year of the three-year plan, dropping to $12.2mn in the 2019/20 year, before reverting to $2.7mn in the 2020/21 year. Increased borrowings (and various other special grants) are a manifestation of the inter-generational equity principle by spreading the funding and subsequent repayments over future ratepayers who benefit. But not for actual borrowing costs incurred.

It should be noted for Kaikoura there is a further anomaly in the 'borrowing costs' accounting policy carried forward from pre-earthquake years. Those audited financial statements note:

> *The financial statement have* [sic] *been prepared in accordance with Tier 2 PBE Accounting Standards Reduced Disclosure Regime, on the basis that the Kaikōura District Council have expenses of more than $2 million and less than $30 million, and is not publicly accountable. These financial statements comply with PBE Standards.*

Yet the Accounting Policy for Borrowing Costs in its pre-earthquake Annual Report was recorded as:

> '*Council has elected to defer the adoption of NZ IAS 23 Borrowing Costs (Revised 2007) in accordance with its transitional provisions that are applicable to public benefit entities. Consequently, all borrowing costs are recognised as an expense in the period in which they are incurred.* [*i.e.* equivalent to the IPSAS 5.14].

4..4 - Auckland Council Accounting Policy

From Table 2 by far the largest level of $-work-in-progress and interest costs across all Local Authorities is attributable to the Auckland Council. Although not stated, and contrary to the IPSAS 5.16 disclosure requirement (and practice for most other Local Authorities), borrowing costs are expensed as incurred. The actual borrowing costs policy is worded as:

> *'Finance costs include interest expense, the unwinding of discounts on provisions and financial assets; and net realised losses on the early close-out of derivatives. Interest expense is recognised using the effective interest method. Included in interest expense is interest on drawn debt and interest rate swaps, and the amortisation of borrowing costs'* (AC 2017/18 Annual Report, Vol. 3, p. 22).

Given intended significant long-term capital budget plans and commitments, the lack of recognition of any *qualifying expenditures* appears contrary to the intent and definitions in the IPSAS 5 Standard. Thus, given a general 'balanced budget' statutory requirement, it is highly likely Auckland ratepayers are incurring higher rate levies and rate increases because of non-capitalisation of borrowing costs attributable to debts incurred on any such qualifying expenditures.

It is reported that the Mayor has stated the AC is virtually at its debt ceiling absolute and relative covenants which is a further benefit of some interest capitalisation. Moreover, as noted earlier, it has not prevented the AC from capitalising $40mn of certain operating expenses, notwithstanding no expressed associated accounting policy, nor any associated explanation or reconciliation of gross (vs. net) expenditures.

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[10] Under the *Hurunui/Kaikōura Earthquakes Recovery Act 2016* and the *Hurunui/Kaikōura Earthquakes Recovery (Local Government Act 2002—Kaikoura District 3-Year Plan) Order 2018* – all Audit provisions have, or appear to have been suspended until no later than June 2021.

5. Justifications for current practice for a non-'borrowing costs' capitalisation policy

When the matter was raised with the WCC at their March 2018 FARMS meeting (refer Appendix 3), the CFO replied subsequently with, *inter alia*, the following points in favour of the WCC's practice of not recognising capitalisation of borrowing costs:

5.1 The AG's report in 2009[11] outlined concerns with capitalisation of borrowing costs in the public sector and noted:

- capitalisation of general borrowings in the public sector is both complicated and arbitrary, and therefore unlikely to enhance the reliability of general purpose financial reports;
- there is no clear way to incorporate a component of borrowing costs into revaluations (sic) of most significant public sector assets, which is likely to make asset revaluations less reliable;
- any benefits of capitalising borrowing costs are significantly outweighed by the compliance costs of initial capitalisation and subsequent revaluation of assets.

These points have been addressed above. This presents little difficulty for the *For-Profit* sector and exhibits a strange view about asset revaluing processes post-recognition. As a consequence, it also raises some uncertainty about the extent to which diminution of fair values features in local authority financial statements, such as for 'white elephant' capital assets or where a Local Authority has greatly exceeded budgets for (presumably) previously justified capital expenditures *(e.g.* the Kaipara District Council Waste Water Plant project; the Island Bay Cycle Way project).

In any case, each of the above objections is discussed and covered in *IPSAS 5.21-29*.

5.2 Other summarised reasons advanced for non-capitalisation of borrowing costs:

5.2.1 Borrowing is done at Council level and not attributed to individual assets. The WCC notes too Treasury do not capitalise borrowing costs in the Government's Accounts for this reason. Their Policy is quoted as '*Generally, Government borrowings are not directly attributable to individual assets. Therefore, borrowing costs incurred during the period, including any that could be allocated as a cost of completing and preparing assets for their intended use are expensed rather than capitalised*' – *i.e.* not recognising *IPSAS 5.18* at all;

5.2.2 If WCC were to adopt that alternative treatment it would require the capitalisation of borrowing costs for all qualifying assets -*i.e.* no apparent recognition of any auditable and realistic materiality policy criteria;

5.2.3 Claimed to be difficult where, for example, expenditure replaces an asset, such as with social housing and infrastructure asset renewals and/or when funded from depreciation extending for 50-100 years for some assets. '*It would be extremely administratively cumbersome, if not impossible to calculate the amount of borrowing (if any] associated with a particular asset*'. Therefore, no capitalisation occurs as policy - notwithstanding proclaimed adherence to the objective of inter-generational equity and the provisions of IPSAS 5;

[11] Attributed Source: The Auditor-General's views on Setting Reporting Standards for the Public Sector – June 2009

5.2.4 *'Even if the amount of borrowings associated with an asset could be calculated the calculation of how much interest to capitalise would also be complex as we have different debt instruments with different rates and at any point of time we could have cash reserves which generate interest income'.* N.B. This is covered in *IPSAS 5.25;*

5.2.5 *'Although discussions with our valuer have determined that it may be possible to factor in borrowing costs it would make the revaluation of PP&E assets extremely complex if some assets included borrowing costs and some didn't as inputs into the valuation would be different'.*

This raises the question whether IPSAS 17 has different 'rules' for Measurement after Recognition as those contained in *NZ IAS 16.* Likewise, post-completion, whether any interest capitalisation ought to be factored into a revaluation exercise anyway;

5.2.6 *'We are not aware of any other local authorities, or indeed any public sector organisations, in New Zealand that are capitalising borrowing costs'* – but refer Item 3 above where six Local Authorities, two of which are Cities, already have the policy to capitalise borrowing costs per IPSAS 17. *'if we were to capitalise borrowing costs it would reduce comparability among local authorities.*
N.B. This assumes comparability assessment/s occur now, refer Table 1 on p.7 – but, if so, for what meaningful purpose;

5.2.7 *'Even if other local authorities chose to capitalise borrowing costs the definition of a 'qualifying asset' is subjective* ***as there is no guidance in the Standard as to what constitutes a 'substantial period of time' [emphasis added]*** *and the amount of borrowings to attribute to an asset could also be subjective if there are multiple debt instruments involved and there are other sources of funding e.g. depreciation.'.*
This is notwithstanding these matters are already covered in IPSAS 5;

But if not, and to avoid uncertainty, then the XRB/IPSASB should reconsider as a matter of urgency the established definitions and relevant content of the *IPSAS 5* Standard vs IAS 23 - in conjunction too possibly with the Auditor-General for his forthcoming LTP and Financial Reporting audits.

6. Conclusion

The Auckland Council's 2017/18 Annual Financial Statements (audited by the Deputy Auditor-General) includes a very helpful summary *'Main differences between IFRS and PBE Accounting Standards'* (AC, Vol 3, pps.109-112)[12]. The purpose is to identify the key differences in recognition and measurement between Public Benefit Entity [PBE] Accounting Standards, applicable to the Auckland Council/Group, and IFRS for annual periods beginning on or after 1 July 2017. There are four PBE Accounting Standards with a comparable IFRS equivalent, and seven Standards that are ascribed as having no IFRS equivalent or where the IFRS equivalent is not comparable.

The '*Borrowing Costs'* Standard is in the former category. It reads **[emphasis added]**

> ***'PBE***
> *PBE IPSAS 5 Borrowing Costs* ***permits*** *PBEs* ***to either capitalise or expense borrowing costs*** *incurred in relation to qualifying assets. A qualifying asset is defined in PBE IPSAS 5 "as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale". The Group's accounting policy is to expense all borrowing costs. As a consequence, borrowing costs are not included in the original cost or revaluations of qualifying assets.*
> ***IFRS***
> *IAS 23 Borrowing Costs requires capitalisation of borrowing costs incurred in relation to qualifying assets. The definition of a qualifying asset is identical to the definition in PBE IPSAS 5*
> ***Impact***
> *This difference results in the Group's property, plant and equipment value, and subsequent depreciation expense, being lower than they would be under IFRS. In addition, there is* ***higher interest expense in the periods in which qualifying assets are constructed.****'*

Thus, and without any further comment on the ambiguity involved, 'qualifying assets', as defined in IPSAS 5.5, are ignored by the Auckland Council/Group entity when adopting IPSAS 5.14 full expensing as its formal Accounting Policy. Thus, the LTP basis for the annual rate levy calculation <u>is over-stated</u> to the detriment of ratepayers under the inter-generational equity principle.

Moreover, this summary pays only lip service, but not practice, by Council (and its Auditor) to the inter-generational equity principle established in the LGA by Parliament. This is best described by the Christchurch City Council (and others) in its *Capital Management* statement (p.212):

> ***'Intergenerational equity***
> *The Council's objective is to manage the balance between rating (for funds) and borrowing to achieve intergenerational equity, which is a principle promoted in the Act and applied by the Council. Intergenerational equity requires today's ratepayers to meet the costs of utilising the Council's assets but does not expect them to meet the full cost of long term assets that will benefit ratepayers in future generations. Additionally, Council has in place asset management plans for the renewal and maintenance programmes of major classes of assets to ensure ratepayers in future generations are not required to meet the costs of deferred renewals and maintenance.*
> *The Act requires the Council to make adequate and effective provision in its LTP and in its Annual Plan (where applicable) to meet the expenditure needs identified in those plans. The Act also sets out factors that the Council is required to consider when determining the most appropriate sources of funding for each of its activities. The sources and level of funding are set out in the funding and financial policies of the Long Term Plan.'*

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[12] Copy attached within Appendix 2, on p.20 below.

7. Recommendations for consideration by the XRB and IPSASB, with the Auditor-General

Local Authorities have the responsibility for (inter alia):

- integrity and appropriateness of internal and external reporting and accountability arrangements; and
- independence and the adequacy of the internal and external audit function.

From the foregoing there are anomalies and inconsistencies in adhering to the *IPSAS* 5 Reporting Standard and to meet the principles, spirit and requirements of the Local Government Act 2002, including the inter-generational equity principle. **These are matters for consideration and implementation by each of the XRB, IPSASB and the Auditor-General for principled consistency**.

Recommendations: the XRB considers urgently with the IPSASB (and the Auditor-General):

7.1 the definition of 'Qualifying Expenditure' in IPSAS 5 (and NZ IAS 23) be reviewed and 'tightened up' for consistency of application and practice, and removal of ambiguity, [*e.g.* IPSAS 5.20] as to recognition, measurement, period of capitalisation and materiality criteria;

7.2 the optionality afforded by IPSAS 5.20 should be removed such that (as in NZ IAS 23) there is only one 'Accepted Treatment'; namely as set out in a <u>renamed</u> IPSAS 5.14 (as amended) as 'The Accepted Treatment', such that IPSAS 5.17+18 becomes redundant;

7.3 Whether the Auckland Council's IPSAS vs IFRS comparisons (in Appendix 2) suggests some modification/s to clarify PBE Standards for accuracy and consistency of application;

Also, that the XRB clarifies with the Auditor-General as a matter of urgency, and with the objective to help ensure Councils adhere to the statutory LGA inter-generational equity principle:

7.4 the Audit NZ Reporting template text be amended (for accuracy) to include provision

- for 'qualifying expenditures' by reflecting IPSAS 5.5 definitions, and the recommended revised IPSAS 5.14 'Accepted Treatment' (per Recommendation 7.2 above);
- the resulting policy be amended **from** *'All Borrowing Costs are expensed in the period in which they are incurred'* **to** a policy narration incorporating capitalised interest on 'qualifying expenditures' – *e.g.* such as accepted by Audit NZ for the Dunedin City Council:

  'Borrowing costs are usually recognised as an expense in the period in which they are incurred.

  Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale';

7.5 as a suggestion, and as a matter of urgency, the Auditor-General include in his forthcoming 2018/19 annual Audit Instruction Letter to his appointed Auditors, and Local Authority auditees:

- An updated formal 'borrowing cost' Accounting Policy, as indicated above;
- Local Authorities be requested to identify in their auditable draft LTP/Annual Plan/ Financial Statements, and in its associated Funding Impact Statement, any appropriate 'qualifying capital expenditure/s' with its/their associated funding; so that the associated borrowing costs are excluded as capitalised interest from the amount otherwise calculated to be raised by the annual Rates income levy. The 'Surplus/(Deficit) of Operating Funding' is therefore reduced (by lower borrowing costs) with compensating increase/s in the Capital Expenditure line item/s (or as a separate line item) so that the net Funding Balance 'bottom line' remains unchanged. The adjustments will therefore properly reflect the inter-generational equity principle contained in the LGA, as mandated by Parliament, and in any Local Authority *Equity Management* statements.

Appendix 1

Table 3 – District & Regional Local Authorities Auditor & Borrowing Costs Treatment

DISTRICT COUNCILS – Their Auditors, 'Borrowing Costs' Accounting Policy per IPSAS 5,

District Council	**Auditor**	**Interest Expensed/ Capitalised**
Ashburton District Council	Audit NZ	Expensed
Buller District Council	Audit NZ	Expensed
Carterton District Council	Audit NZ	Expensed
Central Hawkes Bay District Council	Audit NZ	Expensed
Central Otago District Council	Audit NZ	Expensed
Chatham Islands Council	Audit NZ	Expensed
Clutha District Council	Audit NZ	Expensed
Far North District Council	Audit NZ	Expensed
Gisborne District Council	**EY**	**Capitalised**
Gore District Council	Audit NZ	Expense
Grey District Council	Audit NZ	Expensed
Hastings District Council	Audit NZ	Expensed
Hauraki District Council	Audit NZ	Expensed
Horowhenua District Council	Audit NZ	Expensed
Hurunui District Council	Audit NZ	Expensed
Kaikoura District Council #	**Audit NZ #**	***Expensed***
Kaipara District Council	*Audit* NZ	Expensed
Kapiti Coast District Council	Audit NZ	Expensed
Kawerau District Council	Audit NZ	Expensed
Mackenzie District Council	Audit NZ	Expensed
Manawatu District Council	Audit NZ	Expensed
Marlborough District Council	Audit NZ	Expensed
Masterton District Council	Audit NZ	Expensed
Matamata-Piako District Council	Audit NZ	Expensed
New Plymouth District Council	Audit NZ	Expensed
Opotiki District Council	Audit NZ	Expensed
Otorohanga District Council	**Deloitte**	**Expensed**
Queenstown-Lakes District Council	Audit NZ	Expensed
Rangitikei District Council	Audit NZ	Expensed
Ruapehu District Council	Audit NZ	Expensed
Selwyn District Council	Audit NZ	Expensed
South Taranaki District Council	Audit NZ	Expensed
South Waikato District Council	**Deloitte**	**Expensed**
South Wairarapa District Council	Audit NZ	Expensed
Southland District Council	Audit NZ	Expensed
Stratford District Council	Audit NZ	Expensed
Tararua District Council	Audit NZ	Expensed
Tasman District Council	Audit NZ	Expensed
Taupo District Council	Audit NZ	Expensed

Thames-Coromandel District Council	Audit NZ	Expensed
Timaru District Council	Audit NZ	Expensed
Waikato District Council	Audit NZ	Expensed
Waimakariri District Council	Audit NZ	Expensed
Waimate District Council	Audit NZ	Expensed
Waipa District Council	Audit NZ	Expensed
Wairoa District Council	**EY**	**Expensed**
Waitaki District Council	Audit NZ	Expensed
Waitomo District Council	**Deloitte**	**Expensed**
Western Bay of Plenty District Council	Audit NZ	Expensed
Westland District Council	Audit NZ	Expensed
Whakatane District Council	Audit NZ	Expensed
Whanganui District Council	Audit NZ	Expensed
Whangarei District Council	Audit NZ	Expensed

REGIONAL COUNCILS – Their Auditors, 'Borrowing Costs' Accounting Policy per IPSAS 5,

Regional Council	**Auditor**	**Interest Expensed/ Capitalised**
Bay of Plenty Regional Council	Audit NZ	Expensed
Canterbury Regional Council	Audit NZ	Expensed
Hawke's Bay Regional Council	Audit NZ	Expensed
Manawatu-Whanganui Regional Council	Audit NZ	Expensed
Northland Regional Council	**Deloitte**	**Expensed**
Otago Regional Council	**Deloitte**	**Capitalised**
Southland Regional Council	**Deloitte**	**Capitalised**
Taranaki Regional Council	**Deloitte**	**Capitalised**
Waikato Regional Council	Audit NZ	Expensed
Wellington Regional Council	Audit NZ	Expensed
West Coast Regional Council	Audit NZ	Expensed

Source: LGOIMA & 2018 Annual Reports – District & Regional Council Audited Financial Statements

Pursuant to the *Hurunui/Kaikōura Earthquakes Recovery Act 2016* & the *Hurunui/Kaikōura Earthquakes Recovery (Local Government Act 2002—Kaikoura District 3-Year Plan) Order 2018* – all Audit provisions have or appear to have been suspended until no later than June 2021.

Appendix 2

Main differences between IFRS and PBE Accounting Standards

Introduction

Under the New Zealand Accounting Standards Framework, public sector public benefit entities (PBEs) apply PBE Accounting Standards. The New Zealand Accounting Standards Framework defines public benefit entities (PBEs) as reporting entities "whose primary objective is to provide goods or services for community or social benefit and where any equity has been provided with a view to supporting that primary objective rather than for a financial return to equity holders". Many public sector entities are classified as PBEs. Auckland Council Group (the Group) is classified as a public sector PBE for financial reporting purposes and therefore the financial statements of the Group have been prepared in accordance with PBE Accounting Standards.

The PBE Accounting Standards are primarily based on International Public Sector Accounting Standards (IPSAS). IPSAS are based on IFRS but are adapted to a public sector context where appropriate, by using more appropriate terminology and additional explanations where required. For example, IPSAS introduces the concept of service potential in addition to economic benefits in the asset recognition rules, and provides more public sector specific guidance where appropriate. This is in contrast with IFRS that are written for the for profit sector with capital markets in mind.

Set out below are the key differences in recognition and measurement between PBE Accounting Standards applicable to the Group and IFRS (applicable to annual periods beginning on or after 1 July 2017). Differences that impact only on presentation and disclosure have not been identified.

PBE Accounting Standards with comparable IFRS equivalent

1. Formation of Auckland Council Group

PBE

PBE IFRS 3 Business Combinations contains a scope exemption for business combinations arising from local authority reorganisations. This scope exemption is carried forward from NZ IFRS 3 (PBE) Business Combinations, the standard that was applicable to the Group at the time it was formed on 1 November 2010 as a result of the amalgamation of eight predecessor Auckland local authorities. Under the exemption, all assets and liabilities of the predecessor local authorities were recognised by the Group using the predecessor values of those assets and liabilities. The initial value at which those assets and liabilities were recognised by the Group is deemed to be their cost for accounting purposes.

IFRS

Without the scope exemption, the amalgamation of the predecessor local authorities into the Group would have been accounted for as a business combination under IFRS 3 applying the acquisition method. Under the acquisition method, an acquirer would have been identified and all of the identifiable assets and liabilities acquired would have been recognised at fair value at the date of acquisition.

Impact

The impact of the above accounting treatment is that the carrying value of the assets and liabilities received were not re-measured to fair value and no additional assets and liabilities such as goodwill and contingent liabilities, or a discount on acquisition were recognised as would have been required if the transaction was accounted for as a business combination under IFRS 3.

2. Property, plant and equipment

PBE

In accordance with PBE IPSAS 17 Property, Plant and Equipment, PBEs are required to account for revaluation increases and decreases on an asset class basis rather than on an asset by asset basis.

IFRS

IFRS requires asset revaluations to be accounted for on an asset-by-asset basis.

Impact

Decreases on revaluation will be recognised in operating surplus except to the extent there is sufficient asset revaluation reserves surplus relating to the same class of assets under PBE Accounting Standards, and relating to the same asset under IRFS. This difference could result in higher operating results under PBE Accounting Standards where there is a decrease in the carrying value of an asset. This is because, to the extent that there is sufficient revaluation surplus in respect of the same asset class (as opposed to the same asset), the Group recognises a revaluation decrease in asset revaluation reserves.

3. *Borrowing costs*

PBE

PBE IPSAS 5 Borrowing Costs permits PBEs to either capitalise or expense borrowing costs incurred in relation to qualifying assets. A qualifying asset is defined in PBE IPSAS 5 "as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale". The Group's accounting policy is to expense all borrowing costs. As a consequence, borrowing costs are not included in the original cost or revaluations of qualifying assets.

IFRS

IAS 23 Borrowing Costs requires capitalisation of borrowing costs incurred in relation to qualifying assets. The definition of a qualifying asset is identical to that definition in PBE IPSAS 5.

Impact

This difference results in the Group's property, plant and equipment value, and subsequent depreciation expense, being lower than they would be under IFRS. In addition, there is higher interest expense in the periods in which qualifying assets are constructed.

4. Impairment of Assets

PBE

PBEs apply PBE IPSAS 21 Impairment of Non-Cash-Generating Assets or PBE IPSAS 26 Impairment of Cash-Generating Assets, as appropriate to determine whether a non-financial asset is impaired. PBEs are therefore required to designate non-financial assets as either cash generating or non-cash-generating. Cash-generating assets are those that are held with the primary objective of generating a commercial return. Non-cash-generating assets are assets other than cash-generating assets.

The PBE Accounting Standards require the value in use of non-cash-generating assets to be determined as the present value of the remaining service potential using one of the following: the depreciated replacement cost approach; the restoration cost approach; or the service units approach.

Under the PBE Accounting Standards property, plant and equipment measured at fair value is not required to be reviewed and tested for impairment.

IFRS

IFRS does not provide specific guidance for the impairment of non-cash-generating assets. The value in use of an asset or a cash generating unit is the present value of the future cash flows expected to be derived from an asset or cash-generating unit. The guidance in IAS 36 Impairment of Assets applies to all property, plant and equipment, including those measured at fair value.

Impact

Assets whose future economic benefits are not primarily dependent on the asset's ability to generate cash and may not be impaired under PBE Accounting Standards because of the asset's ability to generate service potential might be impaired under IFRS due to limited generation of cash flows. The Group's asset values may therefore be higher under PBE Accounting Standards because some impairment may not be required to be recognised, that would be required to be recognised under IFRS. Further, the value in use of an asset may be different under PBE Accounting Standards due to differences in calculation methods. Finally, the fact that property, plant and equipment measured at fair value is not required to be reviewed and tested for impairment under the PBE Accounting Standards has no significant impact because these assets are subject to sufficiently regular revaluations to ensure that their carrying amount does not differ materially from their fair value.

PBE Accounting Standards that have no IFRS equivalent / IFRS equivalent is not comparable

The following standards provide guidance on the same or similar topics but are not directly comparable. The comparison below identifies the key recognition and measurement difference.

5. Revenue from non-exchange transactions

PBE

The PBE Accounting Standards require revenue to be classified as revenue from exchange or nonexchange transactions. Exchange transactions are transactions in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange. Non-exchange transactions are transactions that are not exchange transactions.

PBE IPSAS 23 Revenue from Non-Exchange Transactions deals with revenue from nonexchange transactions. The Group's non-exchange revenue includes revenue from general rates, grants and subsidies.

Fees and user charges derived from activities that are partially funded by general rates are also considered to be revenue arising from nonexchange transactions.

The Group recognises an inflow of resources from a non-exchange transaction as revenue except to the extent that a liability is also recognised in respect of the same inflow. A liability is recognised when a condition is attached to the revenue that requires that revenue to be returned unless it is consumed in the specified way. As the conditions are satisfied, the liability is reduced and revenue is recognised.

IFRS

IFRS does not have a specific standard that deals with revenue from non-exchange transactions. IAS 20 Accounting for Government Grants and Disclosure of Government Assistance contains guidance relating to the accounting for government grants. Under IAS 20, government grants are recognised in profit or loss on a systematic basis over the periods in which the entity recognises expenses for the related costs for which the grants are intended to compensate. In the case of grants related to assets, IAS 20 results in setting up the grant as deferred income or deducting it from the carrying amount of the asset.

Impact

Compared to IAS 20, the Group's accounting policy may lead to earlier recognition of revenue from nonexchange transactions; and may also result in differences in asset values in relation to grants related to assets.

As a result of adopting PBE IPSAS 23, the timing of recognising the group's rates revenue has changed to recognise annual general rates revenue as at the date of issuing the rating notices for the annual general rate charge resulting in the entire rates revenue being recognised in the interim financial statements of the Group. This is contrary to the Group's previous accounting policy under NZ IFRS PBE to recognise general rates revenue throughout the annual period. The impact of this difference increases the reported general rates revenue and net assets in the interim financial statements of the group however it has minimal impact on the recognition of revenue and net assets reported in the Group's annual financial statements.

6. Service Concession Arrangements (also known as Public Private Partnership Arrangements)

PBE

PBE IPSAS 32 Service Concession Arrangements deals with the accounting for service concession arrangements from the grantor's perspective. Service concession arrangements are more commonly known as Public Private Partnership (PPP) arrangements. Broadly, service concession arrangements are arrangements between the public and private sectors whereby public services are provided by the private sector using public infrastructure (service concession asset). PBE IPSAS 32 requires the grantor (public entity) to recognise the service concession asset and a corresponding liability on its statement of financial position. The liability can be a financial or other liability or a combination of the two depending on the nature of the compensation of the operator. A financial liability is recognised if the grantor compensates the operator by the delivery of cash or another financial asset. A non-financial liability is recognised if a right is granted to the operator to charge the users of the public service related to the service concession asset (liability for unearned revenue).

IFRS

IFRS contains no specific guidance addressing the accounting by the grantor (public entity) in a service concession arrangement. However, IFRS contains guidance for the operator's accounting (private entity).

Impact

Applying IFRS to service concession arrangements would not result in a significant impact on the Group's financial position or financial performance as, in absence of specific guidance in NZ IFRS, prior to the adoption of PBE Accounting Standards, NZ practice has been to 'mirror' the accounting treatment of the private entity under IFRS which is consistent with the requirements of the PBE Accounting Standards.

7. Consolidated Financial Statements

PBE

PBE IPSAS 6 Consolidated and Separate Financial Statements includes guidance on assessing control to determine whether an entity should be included within the consolidated financial statements of the parent company. It also specifies the accounting treatment for interests in other entities in the separate parent financial statements.

IFRS

IFRS 10 Consolidated Financial Statements contains guidance on assessing control using principles similar to those in PBE IPSAS 6 and provides additional guidance to assist in the determination of control where this is difficult to assess. IAS 27 Separate Financial Statements specifies the accounting treatment for interests in other entities in the separate parent financial statements.

Impact

The Group does not believe that the application of IFRS 10 would result in more or fewer entities being consolidated than under PBE IPSAS 6.

8. Joint Arrangements

PBE

PBE IPSAS 8 Joint Ventures defines three types of joint ventures: jointly controlled assets, jointly controlled operations and joint ventures.

IFRS

IFRS 11 Joint Arrangements focuses on the rights and obligations of the parties to the arrangement rather than its legal form. There are two types of joint arrangements: joint operations and joint ventures.

Impact

The Group does not believe that the application of IFRS 11 would result in a material change to the Group's results and net assets.

9. Fair Value Measurement

PBE

There is no specific standard in the PBE Accounting Standards, however a number of PBE Accounting Standards contain guidance on the measurement of fair value in specific context (for example PBE IPSAS 17 Property, Plant and Equipment and PBE IPSAS 29 Financial Instruments: Recognition and Measurement).

IFRS

IFRS 13 Fair Value Measurement does not extend the use of fair value accounting but provides guidance on how it should be applied where its use is already required or permitted by other standards within IFRSs.

Impact

The application of IFRS 13 may result in differences in the measurement of certain property, plant and equipment compared to PBE IPSAS 17 and financial assets and liabilities compared to PBE IPSAS 29.

10. Employee Benefits

PBE

PBE IPSAS 25 Employee Benefits is based on IPSAS 25. IPSAS 25 is based on IAS 19 Employee Benefits (2004).

IFRS

IAS 19 Employee Benefits (2011) introduces changes to the recognition, measurement, presentation and disclosure of post-employment benefits compared to IAS 19 (2004). The standard also requires net interest expense/income to be calculated as the product of the net defined benefit liability/asset and the discount rate as determined at the beginning of the year.

Impact

The Group has no material defined benefit obligations and therefore there is no impact on its financial performance and financial position.

APPENDIX 3

9 Upland Road,
Kelburn,
Wellington, 6012.
6th March, 2018.

WCC FINANCE, AUDIT & RISK MANAGEMENT Sub-COMMITTEE (FARMS) Meeting at 9.30am on Wednesday, 7th March, 2018

Mr Kevin Lavery,
CEO, Wellington City Council,
Wellington.

Dear Mr Lavery,
I hereby give notice of my wish to address the above meeting during Public Participation on the following Issue relating to Agenda item 2.1.

The Issue raised is whether the Draft 2018 Financial Statements being presented (attached to the Meeting Agenda):

- meet the principles, spirit and requirements of the Local Government Act 2002, including one of the IPSAS formal Accounting Standards, and the principles contained in the Financial Statements for preparing them;
  and taken together
- potentially expose the Council to Audit Risk of non-compliance and/or for a qualified External Audit Statement by Audit New Zealand.

These issues are covered in more detail in the Attachment.

However, as background reference for the foregoing, I note from the Agenda the FARMS has responsibility for (inter alia):

- integrity and appropriateness of internal and external reporting and accountability arrangements; and
- independence and the adequacy of the internal and external audit function.

If you have any query beforehand, please advise; otherwise I would appreciate your confirmation of receipt of this application to attend and address the Meeting under Public Participation.

Thank you,
Yours sincerely;

(Dr) John Milne (Ratepayer)
Mobile: 0274-395-135

ATTACHMENT.

The principal objective of WCC's *Equity Management* is outlined in Agenda 2.1 p.76:

> *'The Local Government Act 2002 (the Act)* ***requires*** *the Council to manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes the* ***current and future interests of the community****. Ratepayer funds are largely managed as a by-product of managing revenues, expenses, assets, liabilities, investments, and general financial dealings* ***[my emphasis]****.*
>
> ***'The objective of managing these items is to achieve intergenerational equity, which is a principle promoted by the Act, and applied by the Council. Intergenerational equity requires today's ratepayers to meet the costs of utilising the Council's assets but does not expect them to meet the full cost of long term assets that will benefit ratepayers in future generations****...*

Applying these intergenerational principles, I concur with the Accounting Policy, for example, for '*Depreciation*' (Note 8, p.30).

That is, whilst an asset is incomplete and unable to contribute resources or save expanses there is no depreciation charge in a current year nor until such time as it is ready-for-use.

The corollary to this is that whilst an asset is under construction *etc.* and is financed by and/or is incurring borrowing costs (as is the case currently for most if not all WCC capital expenditures) then those **interest costs on work-in-progress** should be capitalised to the asset concerned. [NB. I am unable to determine in the Draft Financials the extent of Work-in-Progress].

In Note 6 '*Finance Expense*' (p.26) and in the '*Property, Plant & Equipment*' Note 18 (p.27) the current Policy is

> "*All Borrowing Costs are expensed in the period in which they are incurred*"

Given this; the accounting treatment currently adopted by the WCC is at odds with the over-riding principle of intergenerational equity.

The consequence is that in setting Rates, current Ratepayers are (by policy definition) being charged in the budgeted rate-calculations for non-capitalised borrowing costs on work-in-progress capital expenditures benefitting future ratepayers - so are therefore being over-charged in their rates. The result is the underlying Surplus on Operations is under-stated for a current year and the Rates calculation over-stated.

How has this Policy arisen?

It is possibly a simplified reading of the latest formal Public Benefit Entity IPSAS 5 '*Borrowing Costs*' Accounting Standard applicable to the WCC – which states (IPSAS 5.14) as a '**Benchmark Treatment**'

> *All Borrowing Costs are expensed in the period in which they are incurred*".

However, equally valid and more applicable to the WCC's operations (in scale, type of assets and significance) is IPSAS 5.17 "**The Allowed Alternative Treatment**"

Borrowing Costs ***shall*** *be recognised as an expense in the period they are incurred,* ***except to the extent they are capitalised and in accordance with IPSAS 5:18*** (which states) ***Borrowing Costs that are directly attributable to the requisitioning, construction, or production of Qualifying Assets shall be capitalised to the cost of that asset.***

A Qualifying Asset is defined as "*an asset that necessarily takes a substantial period of time to get ready for its intended use or sale*".

Thus, I believe

- the current *Financing Expense* Policy is insufficient against the inter-generational objective, emphasised by information from Agenda Item 2.4, so
- the FARMS should re-consider forthwith the applicability of the present Note 6 '*Finance Expense*' Accounting Policy to the more appropriate permitted IPSAS 5 ***Allowed Alternative Treatment*** and adjust the Financial Statements accordingly to give credence to the stated objective for intergenerational Equity (which is allegedly currently the case!).

As further commentary in support of this Issue, and proposal, I would note:

- the WCC has some big-ticket capital expenditures under consideration which inevitably will be phased over more than a current accounting period (*e.g.* cycle ways, social housing, new Convention Centre, replacement to the CAB, etc., etc.) necessitating capitalised borrowing costs since rateable income is less than budgeted operational expenditures. The sooner interest capitalisation is implemented for rate determination purposes the better; and
- the WCC appoints two directors to the Wellington International Airport Board (representing the WCC's 34% interest). The WIA '*Borrowing Costs*' Accounting Policy requires interest capitalisation as described above.
  This in turn creates an anomaly given that the WCC consolidates a different interest charging regime (*i.e.* **after** interest capitalisation) in its Equity Associated Earnings of an Associate (refer Note 20, p.58);
- the concurrent Agenda Item 2.4 on the Long Term Plan states (p.168):
  '***With significant capital investments throughout the LTP, debt is forecasted to go up****... the Liability Management Policy is introducing a move towards a "corridor" approach when managing [this interest rate] risk. The corridor approach considers debt forecast figures* ***for every year*** *of the Long-Term Plan, rather than the existing approach that is* ***only forward looking by 12 months****.*
  The following considerations have been taken into account when looking into this change to policy: - ***Increasing debt levels over the 2018/28 Long-Term Plan period*** *- An ability to prudently manage future debt levels over a prolonged period with far greater flexibility than a rolling 12 month forecast period*'.

Accordingly, the current Note 6 Accounting policy is a significant issue being inappropriate for all the reasons given – and an interest capitalisation policy should be implemented for the 2018 Financial year as permitted and contained in IPSAS 5.18.

Mobile: 0274-395-135
Email: jhg.milne@xtra.co.nz

9 Upland Road,
Kelburn,
Wellington, 6012.
24th January 2019.

IPSAS 5 'BORROWING COSTS' and INTER-GENERATIONAL EQUITY

Mr John Ryan,
Controller and Auditor General,
P.O. Box 3928,
Wellington, 6140

By E-mail to:
john.ryan@oag.govt.nz>

Dear Mr Ryan,

I am attaching a letter sent concurrently to Mr Warren Allen, CEO of the External Reporting Board (XRB). That letter is co-signed by Mr Jordan Williams, Executive Director, The New Zealand Taxpayers' Union. A hard copy follows.

The Issue relates to the role of the Auditor-General (along with the XRB Standard Setters) on audits of Long Term Plans (LTP) and Financial Statements of Local Authorities, as mandated by the Local Government Act, 2002 concerning IPSAS 5.

Contrary to what might be expected by your predecessor/s, there's far from uniform methodology and consistency on the treatment of 'Borrowing Costs' across New Zealand's Local Authorities including the statutory requirement for Inter-Generational Equity which many Local Authorities claim to adopt - but most in fact do not.

The attached letter and report highlight part of the issue relates to ambiguity in the Standard itself; but part also relates to the audit responsibility of Auditors appointed by yourself; namely Audit New Zealand and the other Private Sector Auditors, Deloittes and EY. The Recommendations contained in Item 7 on p.16 affect the XRB and, with respect, I believe also yourself and/or the Office of the Auditor-General, with suggested remediation as early as your next 'Audit Instruction Letter' for the formalities required for the 2018/19 LTPs and Financial Reporting Statements.

To provide some context, I estimate, on indicative assumptions, current ratepayers in New Zealand's Cities could be paying of the order of an annual $25-30 mn. more in rates than they should because of this matter. The attached Report explains why.-

If you have any query or require further elaboration, please advise; otherwise I would appreciate your confirmation of receipt of this letter. Thank you,
Yours sincerely;

Dr John Milne
Cc Mr Jordan Williams; jordan@taxpayers.org.nz

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5 April 2019

Dr Milne
PO Box 28-045
Kelburn
Wellington 6150

Dear Dr Milne

IPSAS 5 'BORROWING COSTS' AND INTERGENERATIONAL EQUITY

The Auditor-General, John Ryan, asked me to respond to your letter of 24 January 2019 about *IPSAS 5 'Borrowing Costs' & Inter-Generational Equity.* That letter was accompanied by a letter you sent to Warren Allen, the Chief Executive of the External Reporting Board (XRB), about the same matter. I also note that you emailed John Ryan on 20 February 2019.

Please note that I was appointed as a member of the International Public Sector Accounting Standards Board (IPSASB) during 2018. This response to your letter is made on behalf of the Office of the Auditor-General, not in my capacity as a member of the IPSASB.

In your cover letter to John Ryan, you estimate that ratepayers in New Zealand could be paying up to $30 million more in rates than they should because borrowing costs are not being capitalised to qualifying assets. We think this conflates an accounting issue with a funding issue.

Regardless of how borrowing costs are accounted for, councils need to be able to fund all of their expenditure (both operating and capital expenditure). The options available to councils are broadly rates revenue, user charges and debt. If funding from rates revenue is reduced, funding from one of the other sources will need to increase. This is likely to be an increase in debt, which may not be financially prudent.

Councils need to carefully balance the way in which expenditure is funded, and the accounting for borrowing costs is unlikely to be a significant driver of the funding decisions.

We note that on page 19 of your letter to Warren Allen, you made a series of recommendations for the XRB, IPSASB and the Auditor-General. Essentially those recommendations were to:

- align PBE IPSAS 5 with NZ IAS 23 *Borrowing Costs*, such that borrowing costs are required to be capitalised for qualifying assets;
- update the Audit New Zealand model financial statements for local authorities to align with capitalisation of borrowing costs to qualifying assets; and
- instruct local authorities to include information in their long term plans and financial statements about the borrowing costs for qualifying assets to show that they are not all being funded by the current year's rates revenue, and inform auditors about this.

We comment on each of those below.

Align PBE IPSAS 5 with NZ IAS 23

Whether or not PBE IPSAS 5 should be changed to align it with NZ IAS 23 is a matter for the New Zealand Accounting Standards Board (NZASB) of the XRB to consider.

I am aware that the IPSASB expects to issue a consultation paper soon about measurement. One of the matters included in the paper that the IPSASB will consult on, is the accounting for borrowing costs in the public sector. Once the consultation paper is issued by the IPSASB, I expect that the NZASB will seek comments on the paper from New Zealand constituents.

It is interesting that the consultation paper approved for issue by the IPSASB at its March 2019 meeting, has a preliminary view that all borrowing costs should be expensed. That preliminary view has been reached in the context of the IPSASB's conceptual framework, which acknowledges current and future generations of taxpayers (akin to the principle of intergenerational equity), as a distinguishing feature of the public sector.

We are aware that there is not a straightforward answer to the question of whether borrowing costs should be capitalised for qualifying assets in the New Zealand public sector. Part 5 of your letter to Warren Allen points out some justifications for not capitalising borrowing costs. We think there are valid points for not capitalising borrowing costs, as referred to in that part.

We don't think the compliance costs of capitalising borrowing costs for qualifying assets should be underestimated, and it would be helpful to better understand the cost/benefit equation. It can be complex apportioning borrowing costs, and somewhat arbitrary capitalising them to qualifying assets. Also, the nature of many public sector assets, i.e. infrastructure, can add a layer of complexity, because of the componentisation of infrastructure.

Most public sector assets in New Zealand are revalued. However, there is no clarity over whether and, if so, how borrowing costs should be incorporated when revaluing those assets.

In the private sector, revaluations of assets seek to establish an exit price in an orderly market. In the public sector most assets are never sold. Therefore, it does not make sense that the aim of a revaluation for such assets would be to establish an exit price.

When revaluing a public sector asset, depreciated replacement cost tends to be the default method used to establish the value. With no market for the purchase and sale of the assets, it is unclear what to do about borrowing costs as there is no implicit borrowing that can be incorporated into a depreciated replacement cost valuation.

Without clarity over whether or how to incorporate borrowing costs in a depreciated replacement cost valuation, it is questionable whether the cost should be capitalised initially. All things being equal, if borrowing costs were capitalised initially and the asset revalued on completion without incorporating borrowing costs, there would be a difference between the cost and the valuation, with the cost being higher than the valuation by the amount of the capitalised borrowing costs. That amount would be written off to the revaluation reserve, if there is one, or to expenses.

Where a council has an accounting policy to capitalise borrowing costs to qualifying assets, we currently take a pragmatic approach to the revaluation of infrastructure assets. Those councils don't incorporate a borrowing cost component into their valuations of core infrastructure assets, and we accept that position based on the lack of clarity over how it would be done.

Update the Audit New Zealand model financial statements

Audit New Zealand's model financial statements: Te Motu District Council 2016/17 are designed to show financial statements that comply with generally accepted accounting practice. The model financial statements set out the "benchmark treatment" for borrowing costs as set out in *PBE IPSAS 5*. Although local authorities have the option of using the "allowed alternative treatment", we think it is reasonable for the model to set out the benchmark treatment, particularly given some of the issues with capitalising borrowing costs. We note that on page 7 of the model users are told:

"The model does not address all the possible recognition, measurement, presentation, and disclosure requirements of the PBE accounting standards. Local authorities should not use the model as a substitute for referring to individual accounting standards applicable to their specific circumstances."

Instruct local authorities and inform appointed auditors about borrowing costs

We are comfortable that local authorities have accounting policies which are in line with *PBE IPSAS 5. PBE IPSAS 5* allows for the benchmark treatment and the alternative treatment, and local authorities make individual choices between those options based on their circumstances.

We understand your concern about the principle of intergenerational equity, and whether both of the options for accounting for borrowing costs in PBE IPSAS 5 can align with the principle. Application of the intergenerational equity principle is a matter of judgement. The issues with capitalising borrowing costs as set out in your letter to Warren Allen, some of which I've also commented on, show that it is not straightforward to determine whether such costs should be capitalised to qualifying assets. Your view on this matter is one of a range of views, and we encourage you to express those views to the IPSASB for their consideration.

Given that the IPSASB will be consulting soon on the accounting for borrowing costs in the public sector, as part of its consultation paper on measurement, and it is unclear whether expensing or capitalising of borrowing costs will be required in future, we don't think it makes sense for local authorities or appointed auditors to change current practice right now.

Yours faithfully

Todd Beardsworth
Assistant Auditor-General
Accounting and Auditing Policy

cc Warren Allen
Chief Executive
External Reporting Board