

Audit Adviser

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New look for Grant Thornton – ongoing commitment to your business

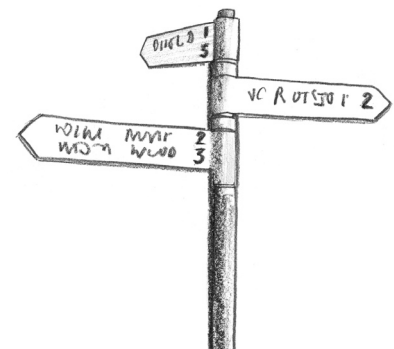
As you see from the masthead above, the Grant Thornton logo has changed in line with changes at Grant Thornton International. We want to take this opportunity to reinforce our commitment to meeting your needs for accounting and business advice and as required, drawing on relevant expertise from more than 80 countries, tailoring it to New Zealand conditions and supporting you to progress your business goals.

The new symbol is based on the concept of the Möbius loop, discovered by German mathematicians and suggesting

reliability, relationships, partnerships, intelligence, strength, dynamism, multi-dimensionality and global qualities. These are among the attributes we aim to bring to our relationships with our clients.

We have been developing a broader range of advisory services in business risk services, corporate finance, valuations, recovery and reorganisation and specialist tax. We also work with a number of clients on a one-to-one basis, offering customised advice across the spectrum of business issues – from business planning

to cost control, estate planning to growth strategies. Please feel free to contact your Grant Thornton adviser if you would like more information on any of these services to support your future business goals.



Grant Thornton Not for Profit survey released

The latest Grant Thornton Not for Profit Survey has been released, if you would like to receive a copy please email: info@gtwn.co.nz, or telephone 04 474 8500. Alternatively the survey can be downloaded from our website: www.grantthornton.co.nz.

The survey again uncovered the most significant issues facing this sector again were financing the activities of the organisation and governance which topped the poll. The retention and motivation of key staff was the biggest

mover in the survey this year with 32% of respondents listing it as the most significant issue facing their organisation, up from 23% in the previous survey. The limited career path offered by some Not for Profits and the inability to match the salaries of the corporate sector can be demotivating factors for employees. Not for Profits need to be creative in developing alternative incentives to attract and retain staff.

If you would like us to help you benchmark your organisation against the

survey or if you would like us to present the key findings to your board, please contact your local office.

Contents

- 01 New look for Grant Thornton
- 01 Not for Profit survey released
- 02 Strong supervisory and internal controls are the best defence
- 03 Impact of NZ IFRS for Retirement Villages
- 04 Where's the value in an audit

Strong supervisory and internal controls are the best defence

We need look no further than the recent and much-publicised rogue trading scandal at a major international investment bank to see what can happen when supervisory and internal controls fail. Over the course of months, a junior level trader allegedly managed to make enormous unauthorised trades totaling upward of \$73 billion that ultimately resulted in a loss of \$7.2 billion for the bank. The effects may have even radiated to the markets, creating volatility as the bank tried to unwind the trades.

Although the ultimate story and facts will take many months or years to come to light, early indications and reports indicate the alleged rogue trader was able to bypass controls because he worked in the 'back office' and had intimate knowledge of how trades were processed. According to published reports, he worked late to disable controls in the bank's computer system to hide his massive trades. The trader also used colleagues' logins and passwords, and employed simple tricks like falsifying emails to thwart his supervisors.

It will be interesting to see in due course if weak internal and supervisory controls are found to have contributed to the recent rash of high profile collapses within the New Zealand economy resulting in large losses to the public. These issues are not limited to the large corporates. Smaller businesses and not for profits are particularly exposed to these risks. Employees are often better placed to take advantage of weak or poorly designed internal and supervisory controls, potentially costing the entity dearly.

The purpose of having supervisory and internal controls in place is to detect and respond to such actions early. However, any organisation must be

diligent in its implementation and follow-through of these controls.

Businesses and directors should take the opportunity to re-examine their own risk management models and systems and focus on enforcing internal and supervisory controls.

Steps toward compliance

The first step is to complete a robust assessment of risk management procedures, internal and supervisory controls. This process includes:

- properly documenting and establishing the extent of supervisory and internal control procedures over all key business areas and remedying issues identified including missing controls, poor segregation of duties and other major weaknesses
- testing the effectiveness of the internal controls in place, including the processes for identification and approval of any overrides of standard procedures
- continuing to maintain current records, documenting systems of internal risk management controls and procedures and considering the impact on these controls of staff and system changes.

Taking responsibility

Second, specific roles must be designated to controls and risk management. The risk management process begins with senior management.

In environments in which there are mounting pressures for staff to perform, the tone must be set from the top that compliance is the main priority, even when there is a decision to be made between internal control and supervisory responsibilities and financial gain. Managers and supervisors must understand that they

are expected to make the right decision and not put the organisation at risk.

In smaller organisation, these roles will often overlap and a practical approach needs to be adopted. This makes the development of clear written policies and procedures more vital.

Third, particularly for larger organisations, an independent internal audit function is essential. It is well accepted that an effective internal audit function is a key element in managing risk within an organisation. The internal audit group should be expected to present a thorough risk assessment to the audit committee, which should also provide independent oversight throughout the audit process. The risk assessment should focus on operational risk, regulatory risk and environmental risk.

Whatever the size of the organisation, the heart of the internal and supervisory control system is the written procedures, which become the basis for the responsibilities for each business unit within the entity. The documentation and procedures must be updated as business conditions change and should be independently tested and verified on a regular basis.

Finally, effective surveillance and monitoring are critical.

As we have seen in the case of the major investment bank and local high profile failures, risk management has been thrust into the limelight and will not be leaving the stage in the foreseeable future. In this environment entities must create a culture of compliance, have strong supervisory and internal controls, and conduct regular testing and risk assessment. When it comes to risk management, the lesson here is to be proactive.

Impact of NZ IFRS for Retirement Villages

Assuming the year end for your retirement village is 31st March, and if New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) are applicable to the entity, the 2008 financial statements will be the first year for adopting the new standards.

We have outlined below some key issues reflecting the transition.

Investment properties

Previous standard: Properties are revalued annually, net of disposal costs, with surpluses taken to a reserve account on the balance sheet thus increasing net assets.

NZ IFRS

Valuations must be based on market value and any movement in the value is taken directly to the Income Statement.

NZ IFRS transition

The revaluation reserve at the transition date will be transferred to retained earnings and all comparatives restated to reflect correct treatment under NZ IFRS.

Occupation licences

Licences vary, however the key components are:

- 1) Occupier's refundable element with differing entitlements relating to the capital growth; and
- 2) Facility fee received covering period of licence.

Occupier's refundable element with Capital Growth Entitlement

Previous standard: Initial payments to the entity for occupation by a resident were recorded as a liability.

Any capital appreciation in the licence value was not accounted for until the resident released the licence and a new occupant commenced under a new licence.

As stated under Investment Properties, all revaluation surpluses were added to reserves.

NZ IFRS

A liability is calculated at each balance sheet date based upon the best estimate of the expenditure required to settle the present obligation. Therefore each movement in property value is split between

- i) the licence holders entitlement, which is added to the liability; and
- ii) the entity's entitlement, which is credited to the Income Statement.

NZ IFRS transition

The principal adjustment will be to re-allocate the revaluation reserve.

Occupier's refundable element without Capital Growth Entitlement

Previous standard: Initial payments to the entity for occupation by a resident were recorded as a liability.

NZ IFRS

A liability is calculated at the balance sheet date based upon the best estimate of the expenditure required to settle the present obligation.

As the occupiers refundable element is deemed repayable on demand, it is a current liability and no adjustments under IFRS are required.

NZ IFRS transition

All occupancy licences on transition are recalculated.

Facility Fees

Previous standard: The majority of schemes recognise the fee as a liability until legal entitlement had been achieved, when it was transferred to income.

NZ IFRS

The fees should be recognised annually over the expected length of occupant's stay.

NZ IFRS transition

All occupancy licences are recalculated on transition and retained earnings adjusted for the portion where entitlement has been used rather than legally earned.

Example:

A retirement village holds \$2m of an occupation licence and the facility fee is 30% (\$600,000).

By 31 March 2006, under the previous standard, the \$600,000 of facility fee income was spread over 5 years with \$240,000 being taken to reserves, as at this date the licences had been issued for 2 years. Under IFRS, the expected occupancy is assessed at 8 years and therefore only \$150,000 (2 years out of 8) should have been taken to reserves. Reserves are therefore reduced by \$90,000 (before considering the effect of tax) and a new liability established under IFRS for "deferred income" of \$90,000.

The income recognised in each year ended 31 March 2007 and 2008 will be less in this example under IFRS by \$45,000.

Overview

The effect of NZ IFRS adjustments is likely to be considerable. Understanding them is important in order to explain to lenders and potential licence holders.

NZ IFRS principals are broadly one of measuring assets and liabilities to current values and spreading income and costs over entitlement. These are valid principals, however any changes require professional advice, Grant Thornton is experienced in the sector and on IFRS principals and can advise you.

Where's the value in an audit?

To many business owners, audits are a necessary evil, imposed on them to meet banking covenants and the requirements of the Companies and Financial Reporting Acts. In our experience, this has genuinely caused negative sentiment amongst business owners to perform a costly compliance exercise.

The legislation requires an audit if a company is an issuer of securities to the public or is unable to get unanimous approval of shareholders not to have an audit. Certain companies with overseas shareholdings in excess of 25% are also forced to have an audit.

Companies falling within the parameters above, or being required to be audited to meet financing covenants should be looking to reverse the thinking about audits and determine the benefits from having such engagements performed.

Our view of the PHB (Privately Held Business) Audit "world" is that business owner needs should be identified and considered throughout the audit process. Most auditors concentrate on the business and the necessity to meet the auditing standards to produce the one page audit report. But beyond basic audit procedures and meeting audit standards, audits of privately held businesses should consider the following:

- Is the business owner lifestyle and needs in sync with the business?
- Where does the owner perceive the business lies in the business life cycle? e.g. start-up, growth, maturity etc
- What has the business owner done about planning for both strategic and short term business needs?
- Does the business owner give timely and reliable information on which to make decisions to align needs and goals?
- Has the business owner structured themselves to protect their assets?
- What does the business owner do about extracting wealth from the business? And then once extracted, protecting that wealth?

Taking these factors into account during the audit means that rather than being a pure compliance exercise, the business

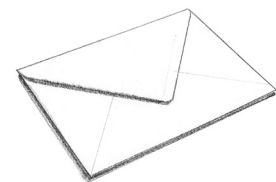
and its owner can derive strategic benefit from the process.

In our Business Owner Audits, the business owner also receives a Key Issues Memorandum about matters arising from the audit and a one-on-one meeting to discuss business owner needs, direction and alignment. As a business owner, you can build on the key issues memorandum to implement action plans to grow your business and meet your personal goals.

We also question whether or not an audit is always required to meet financing obligations. Depending on the level of security and the strength of the business, we often propose to banks that an audit not be undertaken but that a review engagement or an agreed upon procedures review be undertaken. This will allow the bank to ensure that critical areas in your business where they see the most risk can be addressed by independent experts and reported directly to the bank. As with a business owner audit, these types of engagements also include a review of the business owners' needs.

Audit can also be particularly useful for those business owners wishing to grow their business with a defined exit strategy. Acquirers of businesses achieve a much higher level of comfort knowing that the results of the business they are looking to acquire have been independently audited by a reputable firm. This means the time taken to complete due diligence is significantly reduced and confidence for the acquirer is increased. Of course, if the risk for the acquirer is reduced, the multiple increases giving significant returns to the business owner.

With new challenges in today's environment, it is definitely time to consider taking positive proactive steps. The benefits you receive from a Grant Thornton business owner audit will assist you in your planning and direction for the future, on top of meeting statutory requirements.



If you require further information on any of these topics or would like details on other accounting matters, contact your local Grant Thornton firm:

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