

assurance adviser

Grant Thornton 

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Financial fraud, an unpleasant reality

Do you have effective controls to protect your business?

Corporate fraud is flourishing in New Zealand, fuelled by lax internal control frameworks and a lack of awareness and material financial fraud has been identified as one of the key factors in corporate collapse. Prevention of financial fraud remains as one of the major future challenges we face.

Looking at the most recent, significant and highly publicised corporate collapses overseas, the overwhelming majority involved material financial fraud. Companies that collapsed from commercial causes are in the minority. However, collapses such as WorldCom, Enron and Adelphia, each involved systematic fraudulent actions.

Clearly, strong internal controls and probity of an independent audit committee are necessary measures to safeguard against financial fraud. These may be achieved by putting in place effective corporate governance structures and arming its audit committee with a charter to test, detect and root-out fraud.

How internal control provides management assurance

Effective internal controls help safeguard an organisation's assets, prevent irregularity and fraud, promote operational efficiency and encourage adherence to management policies.

Internal control is an integral part of an organisation's management. Its aim is to provide reasonable assurance that the organisation's objectives are being met in the following categories:

- effectiveness and efficiency
- reliability of financial reporting
- compliance with laws and regulations
- safeguarding and accountability of assets (including company's funds and cash)
- preventing and detecting errors and fraud
- achieving targets through effective stewardship of company's resources.

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Financial fraud, an unpleasant reality (Cont.)

Effective internal controls should achieve the following general objectives:

- orderly, ethical, economical, efficient and effective operations
- fulfilling accountability obligations, whereby management and those charged with governance as well as the individuals within the organisation are held responsible for their decisions and actions. These include stewardship and all aspects of performance
- compliance with laws and regulations
- safeguarding resources against loss, misuse, and damage due to waste, abuse, mismanagement, errors, fraud and irregularities.

Making it work...without overkill

In the post-Enron era, there has been criticism that there is overkill in the application of internal controls and corporate governance, spawning a corporate culture of risk avoidance. CFOs, directors and auditors are expressing concerns about the cost of internal controls required by Boards and management to ensure the level of control they have over their companies' systems and processes.

There is a convincing argument that effective internal controls enable management to extract value from the systems and processes they have spent so much time and money embedding in

order to deliver valuable information to management, their investors and auditors.

Managers and regulators need to accept that the effectiveness of an internal control regime is only as good as the culture in which it is embedded.

The central proposition is that implementing a system to prevent fraud is one thing, creating a climate in which people don't wish to commit it is another.

It is therefore the responsibility of management and those charged with governance to:

- integrate cost-effective internal control into all of its operations
- monitor the effectiveness of its internal control operations and the outcomes.

Get back to basics

- improve your culture - understand that fraud is linked with culture and does not depend wholly on internal controls
- automate your controls
- maintain your risk framework
- institute an internal control programme
- ask 'what can go wrong' questions
- conduct a fraud 'health check' - identify red flags.

Ask these questions

- Has your organisation undergone major change such as new responsibilities, reorganisation, funding cuts, expansion of programs, or changes in management?
- Are you understaffed and/or has workload drastically increased?
- Are your staff having difficulties handling operational workload?
- Do your employees understand which behaviour is acceptable or unacceptable?
- Are your employees satisfied or generally disgruntled?
- Is top management aware of actions taken at the lower level of the organisation?
- Is there lack of clarity around roles, responsibilities and accountability?
- Is the organisational structure inefficient or dysfunctional?

Depending on the answers, you may need to address the red flags. We have to recognise that fraud is a real threat. Your business is not immune, but there are ways to protect it. Remember, the way your organisation functions can have a major effect on the incidence of fraud.

Implementation of NZ IFRS and common errors

With the required implementation of NZ IFRS fast approaching, the following are common errors that were noted in the review of recent European IFRS Annual Reports to assist those preparing financial reports.

Incomplete or poorly worded accounting policies

- NZ IFRS accounting policies should not contain old NZ GAAP terminology or vague language
- accounting policies should include all significant accounting policies. Common omissions are;
 - significant judgements, key assumptions and estimates
 - definition of Exceptional items

Incomplete impairment disclosures

- the company should make the following disclosures for each cash generating unit (or group of units) that has goodwill or indefinite life intangibles, even if no impairment is required:
 - carrying amount of goodwill allocated to the unit
 - the carrying amount of intangible assets with indefinite useful lives
 - the basis on which recoverable amount has been determined
 - description of key assumptions used
 - description of management's approach.

First time adoption errors

- it should be clear which exemptions on first-time adoption have been taken
- all adjustments should be clearly explained.

Accounting in the parent entity for share-based payments in the subsidiary

- if subsidiary employees receive equity settled share based payments the parent company should reflect an increase in investment in subsidiary for a capital contribution to the subsidiary.

Incorrect presentation of the Statement of Changes in Equity

- NZ IAS 1 allows for two formats in presenting a statement of changes in equity as a primary statement, either presenting the items in NZ IAS1 paragraph 96 and 97 together - the Statement of Changes in Equity (SOCIE) or presenting only the items in paragraph 96 - the SOCIE.

Where a company recognises actuarial gains and losses outside the income statement, NZ IAS 19 specifically requires a SOCIE to be presented as a primary statement. (IAS 1 paras 96, 97, IAS19 para 92B)

- NZ IAS 32/39 adjustment through the SOCIE - this is a change in accounting policy and needs to be at the foot, and not included in the total income and expense for the period (NZ IAS 1 paragraph 96(d))
- the total income and expense for the period (excluding the prior year adjustment) needs to be split between equity and minority. (NZ IAS 1 paragraph 96 (c)).

Poor application of NZ IAS 32/39

- the narrative required by NZ IAS 32 around hedging and specifically hedge ineffectiveness has been poor

- financial guarantees are in the scope of NZ IAS39 and should be recognised at fair value on initial recognition
- finance costs policy should not be to charge costs as incurred, but recognise using the effective interest method
- hedge (in)effectiveness and P&L geography should be disclosed in the segmental information
- treasury shares need to be deducted from retained earnings and not shown as a separate reserve
- description and disclosure of 'traditional' off-balance sheet items, for example, guarantees and acceptances which may now be on-balance sheet or where related income may be recognised in a different manner, for example, loan commitments are missing.

New standards not disclosed as not yet applied

- an entity must disclose information regarding new standards not yet applied.
- Related party disclosures incomplete, including transactions with:
 - key management
 - associates
 - joint ventures
 - pension schemes.

Note: Just because transactions with or by management are on the same terms and conditions as an external person of a similar standing, or it is the same as for other employees, this is not a valid reason under NZ IAS 24 for non-disclosure.

Early practical experience with equity versus liability classification

Determining whether an instrument is debt or equity (or a combination of both) is not as obvious as many professional advisers and companies may have initially thought. This issue applies to New Zealand International Accounting Standard (NZ IAS) 32: Financial Instruments: Disclosure and Presentation.

NZ IAS 32 treats some shares as debt and requires some instruments (eg convertible debt or some convertible preference shares) to be treated as compound instruments, which involves them being split into liability and equity components on initial recognition.

Take for instance the preference share with the following terms:

- Issued 1.3 million preference shares for \$1.3 million
- Over the next 5 years, the company is required to pay dividends on the preference shares (\$300,000 each year)
- Once all dividends have been repaid the shares will convert into 1.3 million \$1 deferred shares with no voting rights
- The deferred shares are entitled to \$1 per share on winding up of the company, ranking ahead of the ordinary shareholders.

Whilst many would, based on a summary knowledge of FRS 31 and/or NZ IAS 32, intuitively conclude this to be a "debt instrument" a more careful analysis reveals it is in fact a compound instrument.

- The present value of the dividends is a liability component
- The deferred shares appear to have no obligation except in the event of liquidation (equity instrument).

The more general issue to tackle now is to identify the appropriate classification of existing instruments and those that are planned to be issued in the future. Particular issues to watch out for include:

- redemption rights (though non-redeemable shares may still be liabilities)
- conversion rights (eg conversion from debt to shares or from preference to ordinary shares)
- rights to fixed dividends
- whether distributions are at the discretion of the issuer.

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