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Accounting opinion – FPSC asset impairment

Dear Geoff

Health Benefits Limited has asked PricewaterhouseCoopers New Zealand (PricewaterhouseCoopers or PwC) to provide accounting advice on the potential impairment considerations in relation to the Finance, Procurement and Supply Chain (FPSC) project under New Zealand Equivalents to International Financial Reporting Standards (NZ IFRS) as outlined in more detail in Appendix B.

Background

Health Benefits Limited (HBL or the Company) and DHBs are undertaking an FPSC shared services project aimed at reducing costs in administrative support and procurement for the public health sector. The FPSC project is funded by the District Health Boards (DHBs) who are the beneficiaries of those savings. The project is intended to deliver cost savings of circa $519 million over 10 years.

The total original proposed expenditure on the project was $87.9 million, of which $68.3 million was to be capitalised and $19.6 million was operating expenditure. Current spend capitalised to date is circa $45 million; however there is now a high risk that the project will not be delivered within the original budget.

Various options as to how to proceed with the project have been considered. We understand that at the most recent HBL Board meeting on 20 June 2014 it was determined that the preferred option was to continue to complete the HBL FPSC project in line with the original business case.

However, this option is subject to completing a planning exercise to fully determine the revised cost of the project, with formal approval from the DHBs required at the end of this exercise in the form of a "go/no go" decision. To this end a change request to the original business case including a detailed revised cost and benefit model will be presented to each of the DHBs for consideration.

In light of the fact that there is uncertainty regarding the future of the FPSC project, you have asked us to comment on the impairment considerations at 30 June 2014 for both HBL's FPSC tangible (hardware) and intangible (software) assets and the DHB's intangible asset (being a contractual right to receive shared services using the assets funded).

Opinion

Our detailed opinion is included in Appendix A to this letter and is summarised below:

Given the decision made at HBL's 20 June 2014 board meeting, our opinion is based on the assumption that, at 30 June 2014, the 'best estimate' of HBL's and the DHBs' management is that the FPSC project will proceed and that funds will be made available to complete the programme. However, given the current uncertainty regarding the future of the FPSC project, we also comment, in a separate section, on the implications should this 'best estimate' change as a result of events subsequent to balance date.

NZ IAS 36 (PBE) requirements

Under NZ IAS 36 (PBE), an asset is impaired when its carrying amount exceeds its recoverable amount, being the higher of fair value less costs to sell (FVLCTS) and value in use.

An entity should assess, at the end of each reporting period, whether there is any indication that an asset may be impaired. If any such indication exists, the recoverable amount of the asset should be estimated. Irrespective of whether there is any indication of impairment, an entity shall also test an intangible asset with an indefinite useful life or an intangible asset that is not yet available for use for impairment annually.

NZ IAS 36 PBE states that where the future economic benefits of an asset are not primarily dependent on the asset's ability to generate net cash inflows, and where the entity would, if deprived of the asset, replace its remaining future economic benefits, value in use shall be determined as the depreciated replacement cost (DRC) of the asset.

Application of NZ IAS 36 PBE to HBL's FPSC assets

We understand that the FPSC project includes the acquisition/development of tangible assets (hardware) and a definite life intangible asset(s) (software).

In line with the above requirements, the FPSC project assets (both tangible and intangible) should be assessed for any indicators of impairment. Only if there is an indication of impairment should the recoverable amount of the tangible assets be estimated. The finite life software is not yet available for use and so should also be tested for impairment at 30 June 2014 irrespective of whether an indication of impairment exists.

Nature of the FPSC assets being tested for impairment

Before considering the application of the above requirements further, it is helpful to consider the nature of the asset being considered for impairment. The purpose of the FPSC asset is not to generate cash inflows but to support the delivery of health services to the community. Put another way, the FPSC asset is a 'non-cash generating asset' as defined in PBE IPSAS 21 because the asset is not held with the primary objective of generating a commercial return.

Assessment for indicators of impairment

Given that the tangible and intangible assets arising from the FPSC project are integral to each other and the cost savings are driven by both elements being present and operating together, in our view the tangible and intangible assets should be considered together for the purposes of assessing whether there is any indication that the assets may be impaired.

We understand that the anticipated cost savings from the FPSC project have not been revised; that is, there is no indication that the service potential of the FPSC assets will be worse than expected (one of the indications of impairment that at a minimum should be considered). However, an asset is impaired if it is unable to generate sufficient future economic benefits or service potential to recover its carrying amount. Therefore, in our view, because the carrying amount is expected to be higher than originally anticipated (and therefore the 'return' on investment is expected to be lower), there is an indicator of impairment.

Therefore, the tangible assets arising from the FPSC project should be tested for impairment at 30 June 2014. The intangible assets (software) under development should also be tested for impairment irrespective of the above assessment that there is an indicator of impairment because those assets are not yet available for use.

Impairment testing

Impairment testing requires a comparison of the asset's carrying amount to the higher of FVLCTS and value in use.

In our view, value in use shall be determined as depreciated replacement cost or 'DRC'. This is because the future economic benefits of the FPSC assets are not primarily dependent on the assets' ability to generate net cash inflows, and we expect HBL would, if deprived of the asset, replace its remaining future economic benefits since the present value of the cost savings expected to be generated by the FPSC asset exceed the revised cost to complete the project.

For some of the hardware assets, it may be possible to determine FVLCTS. However, given the bespoke nature of the software and the fact that it is under development at year end, determination of FVLCTS for this element of the project is unlikely to be practical. If there is no basis for making a reliable estimate of the amount obtainable for the FPSC assets in an arm's length transaction between knowledgeable and willing parties, HBL may use the asset's value in use (DRC in this case) as its recoverable amount.

Determination of DRC

DRC is an estimate of the cost to replace the asset's gross service potential, determined on an optimised basis (i.e. adjusting for obsolescence, overdesign or overcapacity) and adjusting for depreciation to reflect the already consumed or expired service potential of the asset.

In our view, given that the FPSC project commenced in 2012 and is still in progress DRC is likely to equate, in all material respects, to the costs capitalised to date on the project subject to significant changes in price of components of the FPSC project, adjustments required to eliminate any project inefficiencies, overdesign or overcapacity and technological advancements that would affect the replacement cost of an optimised asset. No adjustment for depreciation will be required as the assets are not yet available for use.

Therefore, subject to the above, in our view, there appears to be no impairment of the FPSC assets at 30 June 2014.

Application of NZ IAS 36 PBE to the DHB's intangible asset

The DHB's intangible asset should be assessed for any indicators of impairment. However, as it has been determined to have an indefinite life, it should be tested for impairment annually irrespective of whether an indication of impairment exists.

Nature of the intangible asset being tested for impairment

The DHB's intangible asset reflects the right to access shared services provided using the FPSC assets in order to generate DHB cost savings in delivering health services to the community. Consistent with the nature of the underlying FPSC assets, in our view, the intangible asset is a 'non-cash generating asset' as defined in PBE IPSAS 21.

Assessment for indicators of impairment

In our view, there is an indication that the DHB's intangible asset is impaired if there is an indication that the underlying FPSC assets, considered together, are impaired. This is because the DHB's intangible asset represents the right to access shared services provided using the FPSC assets. There is an indicator of impairment of the FPSC assets and therefore there is an indicator that the DHB's intangible asset is impaired.

Impairment test

From a practical point of view it is unlikely that FVLCTS of the DHB's intangible asset will be determinable as there is no active market for this asset. Therefore, in our view, the recoverable amount will be determined based on the asset's value in use i.e. for a non-cash generating asset, its DRC.

Determination of DRC

In our view, the DRC of each DHB's intangible asset will equate to its share (based on relative funding contributions) of the DRC of the underlying FPSC assets in HBL. As noted above, the DRC of the FPSC project is likely to equate, in all material respects, to the costs capitalised to date. Consequently, in our view, there does not appear to be any impairment of the DHB's intangible asset at 30 June 2014.

Impact of a change in the intention to complete the FPSC project subsequent to balance date

Should management's 'best estimate' that the FPSC project will proceed as planned change as a result of a decision to discontinue either all or part of the FPSC project, this could have implications for the impairment considerations and the financial statements at 30 June 2014. The extent of the implications rests on whether the decision to re-scope the project is an 'adjusting' or 'non-adjusting' event under NZ IAS 10 PBE.

Given that at the reporting period end, it was known that the costs to complete the FPSC project would be higher than expected and that further funds would need to be made available by the DHBs/the Crown to complete the project, on balance, we believe that any subsequent "no-go" decision to re-scope the project, which is outside the control of HBL, is likely to be an 'adjusting event', providing further evidence of a condition that existed at year end i.e. the level of availability of funds from the DHBs/the Crown.

Therefore, if such a decision was made prior to the financial statements being authorised for issue, in our view, FPSC assets or components of assets from which no future economic benefits are **now expected** from use or disposal (as a result of the 'adjusting event') should be derecognised. This would give rise to a loss on disposal in the income statement. To the extent that the FPSC project is not discontinued in its entirety, the re-scoping of the project would result in revised costs to complete and a revised (and presumably lower) level of benefits or service potential. This would be an impairment indicator. A revised DRC would need to be determined based on the optimised cost of delivering the re-scoped project. If this is lower than the carrying amount of the remaining assets, an impairment loss should be recognised in the income statement.

In our view, the DHBs' intangible asset would be similarly affected and would need to be tested for impairment based on a revised DRC for the re-scoped project (and taking into account each DHB's proportionate funding of that re-scoped project).

Disclosure

The current uncertainty regarding the future of the FPSC project necessitates the need for management to exercise judgement regarding the most likely outcome of the project and the consequences of that for the recoverable amount of the FPSC assets/DHB intangible assets recognised at 30 June 2014.

We therefore recommend comprehensive disclosure of management's impairment considerations including the basis on which recoverable amount of the assets has been determined, the key assumptions on which management has based its determination of DRC and the uncertainties regarding the outcome of the FPSC project.

Responsibility and Restrictions

The ultimate responsibility for the decision on the appropriate application of generally accepted accounting practice rests with Health Benefits Limited.

Our advice has been based solely on the documentation, assumptions and representations provided to us as set out in this letter. Should any of these alter, the final legal documents entered into between the parties change from the terms advised to us, or if there are any other arrangements between the parties pertinent to the accounting treatment of which we haven't been advised, our conclusions may change. Our advice could be affected by the issue of future applicable financial reporting standards, or by future legislation or regulations. We do not take responsibility for advising you of changes in our views as a result of such developments subsequent to the date of this letter.

The opinion has been prepared for the management of Health Benefits Limited for their sole purposes. It should not be used or relied upon by any other person for any purpose, and we specifically disclaim responsibility to any other party for reliance on the contents thereof. The opinion should not be released to any third party, without our prior written consent. In this regard, we consent you to releasing this opinion to the District Health Boards and to their auditors.

Should you wish to discuss the contents of this letter, please do not hesitate to contact Lyn Hunt on (09) 355 8863 or me on (09) 355 8543.

Yours faithfully

Michele Embling

Partner

Appendix A

Background

HBL and DHBs are undertaking an FPSC shared services project aimed at reducing costs in administrative support and procurement for the public health sector. The FPSC project is funded by the DHBs who are the beneficiaries of those savings. The project is intended to deliver cost savings of circa $519 million over 10 years.

As set out in our opinion dated 20 November 2012 the total original proposed expenditure on the project was $87.9 million, of which $68.3 million was to be capitalised and $19.6 million was operating expenditure. The DHBs contributed the $19.6 million in operating expenditure by way of revenue funding to HBL. To fund the capital component, $68.3 million of non-voting 'B' shares were issued by HBL to the DHBs and are called as required by HBL.

This arrangement involved the DHBs signing up to two things: 'B' shares (albeit with a negligible value), and rights under a contract. We expected the value of the 'B' shares (i.e. the value of the 'ownership benefits' conferred to the holders of 'B' shares, being the financial interest in the residual value of FPSC assets in the event of a wind up of HBL) to be negligible both on initial recognition and as long as HBL continues to operate the FPSC assets to provide shared services indefinitely. Therefore, we concluded that the capital funding predominantly represents an intangible asset, being a contractual right to access shared services provided using the assets funded. The intangible asset is recognised as 'B' shares are called and is measured at cost, being the amount of funding contributed. We understand that the intangible asset has been determined by the DHBs to have an indefinite life. Therefore, subsequent to initial recognition, the intangible asset will be measured at cost less accumulated impairment losses.

In turn, as funding is received from the DHBs, HBL will recognise a liability in the form of a 'performance obligation' to provide access to shared services using assets funded. Generally, the consideration received in exchange for a performance obligation is recognised over the period that services are provided. However, since the obligations under the contract are considered to have an indefinite life (consistent with the life of the DHBs' intangible asset), the performance obligation will remain as a liability until either the termination of the contract by the DHBs or the wind up of HBL.

As the funding is spent by HBL on the FPSC project, it recognises an FPSC asset consisting of tangible assets (hardware) and a definite life intangible asset (software). The assets will be held at cost and, therefore, subsequent to initial recognition will be carried at cost less any accumulated depreciation/amortisation and any accumulated impairment losses.

Current spend on the FPSC project capitalised to date is circa $45 million; however there is now a high risk that the project will not be delivered within the original budget. Various options as to how to proceed with the project have been considered with three options proposed by the Steering Committee to the HBL Board.

We understand that the first option was for the DHBs to continue using the existing Enterprise Resources Planning (ERP) system, incorporating only the national procurement function developed as part of the FPSC project. Option two was to apply the design developed for the HBL system to the current healthAlliance system in order to meet national requirements and still deliver the project's full scope. The third option was to deliver the full original project scope using all previous design and build work carried out to date.

We understand that at the most recent HBL board meeting on 20 June 2014 it was determined that the preferred option was to continue to complete the HBL FPSC project in line with the original business case.

However, this option is subject to completing a planning exercise to fully determine the revised cost of the project, with formal approval from the DHBs required at the end of this exercise in the form of a "go/no go" decision. To this end a change request to the original business case including a detailed revised cost and benefit model will be presented to each of the DHBs for consideration.

In light of the fact that there is uncertainty regarding the future of the FPSC project, you have asked us to comment on the impairment considerations at 30 June 2014 for both HBL's FPSC tangible (hardware) and intangible (software) assets and the DHB's intangible asset (being a contractual right to receive shared services using the assets funded).

We have assumed that the costs capitalised to date met the criteria for recognition in NZ IAS 16 PBE and NZ IAS 38 PBE at the point they were incurred i.e. it was probable that future economic benefits would flow and the cost could be measured reliably (NZ IAS 16 PBE p.7/NZ IAS 38 PBE p.21) and that the software under development further met the requirements of NZ IAS 38 PBE p.57 (i.e. completion was technically feasible, the intention was to complete the asset, there was an ability to use or sell the asset, the intangible asset was expected to generate probable future economic benefits, the resources were available to complete the development and the expenditure could be reliably measured).

Detailed opinion

As noted above, there is uncertainty regarding the future of the FPSC project due to a current expectation that the project will not be delivered within the original budget of $87.9 million. We understand that the expected cost savings arising from the project remain unchanged and that it is still worthwhile to proceed with the project based on a revised budget of $115 million. However, the higher project costs will clearly affect the 'return' from the DHB's investment and the additional funds to complete the project will still need to be made available, ultimately by the Crown, if the project is to proceed as originally planned.

Given the decision made at HBL's 20 June 2014 board meeting, our opinion is based on the assumption that, at 30 June 2014, the 'best estimate' of HBL's and the DHBs' management is that the FPSC project will proceed and that funds will be made available to complete the programme. However, given the current uncertainty regarding the future of the FPSC project, we also comment, in a separate section, on the implications should this 'best estimate' change as a result of events subsequent to balance date.

NZ IAS 36 (PBE) requirements

Under NZ IAS 36 (PBE), an asset is impaired when its carrying amount exceeds its recoverable amount, being the higher of fair value less costs to sell (FVLCTS) and value in use.

An entity should assess, at the end of each reporting period, whether there is any indication that an asset may be impaired. If any such indication exists, the recoverable amount of the asset should be estimated (NZ IAS 36 PBE p.9).

Irrespective of whether there is any indication of impairment, an entity shall also [*emphasis added*] test an intangible asset with an indefinite useful life or an intangible asset that is not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount (NZ IAS 36 PBE p.10).

FVLCTS is defined as "*the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal*". Costs of disposal are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense (NZ IAS 36 PBE p.6).

Value in use is defined as "*the present value of the future cash flows expected to be derived from an asset or cash-generating unit*" (NZ IAS 36 PBE p.6). However, paragraph NZ32.1 of NZ IAS 36 PBE states that where the future economic benefits of an asset are not primarily dependent on the asset's ability to generate net cash inflows, and where the entity would, if deprived of the asset, replace its remaining future economic benefits, value in use shall be determined as the depreciated replacement cost (DRC) of the asset.

It is not always necessary to determine both an asset's fair value less costs to sell and its value in use. If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount (NZ IAS 36 PBE p.19).

Sometimes it may not be possible to determine fair value less costs to sell because there is no basis for making a reliable estimate of the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable and willing parties. In this case the entity may use the asset's value in use as its recoverable amount (NZ IAS 36 PBE p.20).

Application of NZ IAS 36 PBE to HBL's FPSC assets

We understand that the FPSC project includes the acquisition/development of tangible assets (hardware) and a definite life intangible asset(s) (software).

In line with the above requirements, the FPSC project assets (both tangible and intangible) should be assessed for any indicators of impairment.

Only if there is an indication of impairment should the recoverable amount of the tangible assets (acquired or in progress) be estimated.

However, as the development of the finite life software is in progress at year end i.e. it is "not yet available for use", it should also be tested for impairment at 30 June 2014 irrespective of whether an indication of impairment exists. Subsequent to 30 June 2014 (and assuming that the FPSC project proceeds), once the software is available for use, it should be tested for impairment only when there is an indicator of impairment, consistent with the requirements for the tangible assets arising from the FPSC project.

Nature of the FPSC assets being tested for impairment

Before considering the application of the above requirements further, it is helpful to consider the nature of the asset being considered for impairment. The purpose of the FPSC asset is to enable the efficient delivery of non-clinical shared-services to DHBs, which support the delivery of clinical services by the DHBs to patients; that is, the primary purpose of the asset is not to generate cash inflows but to support the delivery of health services to the community.

Put another way, the FPSC asset is a 'non-cash generating asset' as defined in PBE IPSAS 21 (applicable for the DHBs'/HBL's financial years ending 30 June 2015 onwards) because the asset is not held with the primary objective of generating a commercial return. The asset's primary objective is to support the efficient delivery of health services for community/social benefit.

Assessment for indicators of impairment

As noted above, in line with the requirements of NZ IAS 36 PBE, the FPSC project assets (both tangible and intangible) should be assessed for any indicators of impairment.

The question arises as to whether the tangible (hardware) assets and intangible (software) assets should be assessed for indicators of impairment separately or by considering whether there is an indication that the FPSC asset as a whole is impaired.

Given that the tangible and intangible assets arising from the FPSC project are integral to each other and the cost savings are driven by both elements being present and operating together, in our view the tangible and intangible assets should be considered together for the purposes of assessing whether there is any indication that the assets may be impaired.

NZ IAS 36 (PBE) lists a series of indications of impairment that at a minimum should be considered. One such internal indicator of impairment is that "*evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected*" (NZ IAS 36 PBE p.12(g)). The term 'economic performance' is not particularly useful in the context of non-cash generating assets. In this regard, PBE IPSAS 21 is more helpful, stating that an internal indicator of impairment is that "*evidence is available from internal reporting that indicates that the* <u>*service potential*</u> *of an asset is, or will be, significantly worse than expected*" (PBE IPSAS 21.27(f)). Paragraph 32 of PBE IPSAS 21 goes on to state that "*This includes the existence of:*

(a) Significantly higher costs of operating or maintaining the asset, compared with those originally budgeted; and

(b) Significantly lower service or output levels provided by the asset, compared with those originally expected due to poor operating performance."

Service potential is also discussed in the Conceptual Framework ED 2 (Elements and Recognition) dated November 2012. Paragraph 2.3 of the ED notes that "*The benefits provided by a resource are service potential or economic benefits. Service potential is the capacity of an asset to be used by the entity to provide goods or services that contribute to achieving the entity's objectives. Service potential enables an entity to achieve its objectives without necessarily generating cash inflows*". Paragraph 2.5 goes on to state that "*Economic benefits take the form of cash inflows or a reduction in cash outflows. Cash inflows (or reduced cash outflows) may be derived from (a) an asset's use in the production or sale of goods or services;...*"

It is clear, then, that consideration of the service potential of a non-cash generating asset should involve consideration of both the capacity/output of the asset and the economic benefits of the asset (either cash inflows or reduced cash outflows).

The existing financial management system (and related assets) currently enables the existing finance, procurement and supply chain processes that support the delivery of health care services by the DHBs to patients; that is, the existing assets have the capacity to be used to contribute to achieving the entity's objectives.

The FPSC assets (which will replace the existing financial management system and related assets) also has the capacity to be used to contribute to achieving the entity's objectives but at a lower cost. It follows, therefore, that the FPSC assets have a greater "service potential" in the form of a reduction in cash outflows and that it is economic to replace the existing assets with the FPSC assets if the present value of this greater service potential exceeds the cost of the asset - the basis of the business case for the project.

We understand that the anticipated cost savings from the FPSC project have not been revised; that is, there is no indication that the service potential of the FPSC assets will be worse than expected. However, an asset is impaired if it is unable to generate sufficient future economic benefits or service potential to recover its carrying amount. Therefore, in our view, because the carrying amount is expected to be higher than originally anticipated (and therefore the 'return' on investment is expected to be lower), there remains an indicator of impairment.

Therefore, the tangible assets arising from the FPSC project should be tested for impairment at 30 June 2014. The intangible assets (software) under development should also be tested for impairment irrespective of the above assessment that there is an indicator of impairment because those assets are not yet available for use.

Impairment testing

Impairment testing requires a comparison of the asset's carrying amount to the higher of FVLCTS and value in use.

For some of the hardware assets, it may be possible to determine FVLCTS. However, given the bespoke nature of the software and the fact that it is under development at year end, determination of FVLCTS for this element of the project is unlikely to be practical. If there is no basis for making a reliable estimate of the amount obtainable for the FPSC assets in an arm's length transaction between knowledgeable and willing parties, HBL may use the asset's value in use as its recoverable amount (NZ IAS 36 PBE p.20).

As discussed above, the purpose of the FPSC asset is <u>not</u> to generate cash inflows but to support the delivery of health services to the community. As the future economic benefits of the FPSC assets are not primarily dependent on the assets' ability to generate net cash inflows, and where the entity would, if deprived of the asset, replace its remaining future economic benefits, value in use shall be determined as depreciated replacement cost or 'DRC'.

DRC is an estimate of the present value of the remaining service potential of an asset. Replacement cost is the cost to replace the asset's gross service potential, determined on an optimised basis (i.e. adjusting for obsolescence, overdesign or overcapacity). Optimisation is applied only to the extent that it reflects the most probable use of the asset that is physically possible, appropriately justified, legally permissible and financially feasible (NZ IAS 16 PBE p.NZ33.10). DRC is replacement cost after adjusting for depreciation to reflect the already consumed or expired service potential of the asset.

Therefore, in our view, the FPSC assets should be tested for impairment by determining their DRC (or, for the tangible hardware assets, FVLCTS if this is higher).

Determination of DRC

As noted above, NZ IAS 36 PBE p.NZ 32.1 states that, for a non-cash generating asset, "*where the entity would, if deprived of the asset, replace its remaining future economic benefits, value in use shall be determined as the depreciated replacement cost of the asset.*"

Therefore, in determining DRC, it is first necessary to consider whether HBL would, if deprived of the FPSC assets (taken together for the reasons outlined above), replace their remaining future economic benefits or 'service potential'.

Subject to funds being available, it seems that if the present value of the cost savings expected to be generated by the FPSC asset exceed the revised cost to complete the project of $115 million then, HBL would, if deprived of the FPSC assets, replace their service potential and should determine value in use as the DRC of the FPSC assets.

In our view, given that the FPSC project commenced in 2012 and is still in progress DRC is likely to equate, in all material respects, to the costs capitalised to date on the project subject to:

- Significant changes in the price of components of the FPSC project;
- Adjustments required to eliminate any project inefficiencies, overdesign or overcapacity;
- Technological advancements that would affect the replacement cost of an optimised asset.

No adjustment for depreciation will be required as the assets are not yet available for use.

Therefore, subject to the above, in our view, there appears to be no impairment of the FPSC assets at 30 June 2014.

Application of NZ IAS 36 PBE to the DHB's intangible asset

The DHB's intangible asset, being a right to access shared services provided using the FPSC assets, has been determined to have an indefinite life.

In accordance with the requirements of NZ IAS 36 PBE, the DHB's intangible asset should be assessed for any indicators of impairment. However, as the intangible asset has an indefinite life, it should also be tested for impairment annually, irrespective of whether an indication of impairment exists, by comparing its carrying amount with its recoverable amount (being the higher of FVLCTS and value in use).

Nature of the intangible asset being tested for impairment

The DHB's intangible asset reflects the right to access shared services provided using the FPSC assets in order to generate DHB cost savings in delivering health services to the community. Consistent with the nature of the underlying FPSC assets, in our view, the primary purpose of the intangible asset is not to generate cash inflows but to support the efficient delivery of health services to the community; that is, the intangible asset is a 'non-cash generating asset' as defined in PBE IPSAS 21.

Assessment for indicators of impairment

In our view, an indication that the underlying FPSC assets, considered together, are impaired is an indication (though it may not be the only indication) that the DHB's intangible asset is impaired. This is because the DHB's intangible asset represents the right to access shared services provided using the FPSC assets. Put another way, anything that affects the future economic benefits or service potential expected to be recovered from the FPSC assets will also directly affect the future economic benefits or service potential of the intangible right to access those assets.

As noted above, there is an indicator of impairment of the FPSC assets. This is also, therefore, an indicator that the DHB's intangible asset may be impaired.

Impairment test

Impairment testing requires a comparison of the asset's carrying amount to the higher of FVLCTS and value in use. From a practical point of view it is unlikely that FVLCTS of the DHB's intangible asset will be determinable as there is no active market for this asset. Therefore, in our view, the recoverable amount will be determined based on the asset's value in use i.e. for a non-cash generating asset, its DRC.

Determination of DRC

In our view, the DRC of each DHB's intangible asset will equate to its share (based on relative funding contributions) of the DRC of the underlying FPSC assets in HBL. As noted above (and subject to the considerations outlined), the DRC of the FPSC project is likely to equate, in all material respects, to the costs capitalised to date. Consequently, in our view, there does not appear to be any impairment of the DHB's intangible asset at 30 June 2014.

We would note that although the DRC of the DHB's intangible asset might be simple to determine at 30 June 2014 as it will practically equate to the current spend to date on the FPSC project, the DRC of the FPSC assets and, therefore, the DHB's intangible asset will be more difficult to estimate going forward. Calculating the DRC involves determining the least-cost reproduction cost of the remaining service potential of the asset. This involves adjusting for any obsolescence, over-engineering or excess capacity. Estimating the cost of reproducing the FPSC asset will get more difficult as more time passes and technological advances are made. This is something to consider going forward.

Impact of a change in the intention to complete the FPSC project subsequent to balance date

As outlined above, our opinion is based on the assumption that, at 30 June 2014, the 'best estimate' of HBL's and the DHBs' management is that the FPSC project will proceed and that funds will be made available by the Crown. This is supported by the fact that the present value of the cost savings expected to be generated by the FPSC assets are still expected to exceed the revised cost to complete the project of $115 million.

In this scenario, we have concluded above that there is unlikely to be an impairment of the FPSC assets or the DHB's intangible asset, subject to significant changes in price of components of the FPSC project, adjustments required to eliminate any project inefficiencies, overdesign or overcapacity and technological advancements that would affect the replacement cost of an optimised asset.

However, we have addressed below the impairment implications should this 'best estimate' change as a result of a decision to discontinue either all or part of the FPSC project subsequent to balance date but before the financial statements are approved.

We understand that once a revised budget has been finalised for completion of the project, this budget will be taken to the DHBs for a "go/no go" decision. A question arises as to whether a decision to re-scope the project subsequent to balance date but before the financial statements are approved is an adjusting or non-adjusting event under NZ IAS 10 PBE *Events after the Reporting Period*?

NZ IAS 10 PBE defines 'events after the reporting period' as *"events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue"* (NZ IAS 10 PBE p.3). There are two types of events: 'adjusting events' (those that provide evidence of conditions that existed at the end of the reporting period) and 'non-adjusting events' (those that are indicative of conditions that arose after the reporting period). Under NZ IAS 10 PBE the financial statements shall be adjusted to reflect an adjusting event but an entity shall not adjust its financial statements to reflect a non-adjusting event. However, to the extent that a non-adjusting event is material, its nature and an estimate of its financial effect should be made (NZ IAS 10 PBE p.21).

Determination of whether an event after the reporting period is 'adjusting' or 'non-adjusting' can be a judgemental area. Ultimately, this requires management to consider whether the event confirms a condition that existed at the reporting period end.

At the reporting period end, it was known that the costs to complete the FPSC project would be higher than expected and that further funds would need to be made available to complete the project. However, there was a lack of certainty regarding the quantum of those costs and the availability of further funds from the DHBs/the Crown. It was this uncertainty that led to a deferral of the "go/no go" decision pending a full planning exercise to more accurately determine the revised cost of the project.

With this in mind, on balance, we believe that any subsequent "no-go" decision to re-scope the project, which is outside the control of HBL, is likely to be an 'adjusting event' providing further evidence of a condition that existed at year end i.e. the level of availability of funds from the DHBs/the Crown. Therefore, if such a decision was made prior to the financial statements being authorised for issue, in our view, this would affect the 30 June 2014 year end position of HBL as follows:

- FPSC assets or components of assets from which no future economic benefits are **now expected** from use or disposal (as a result of the 'adjusting event') should be derecognised (NZ IAS 16 PBE p.67/NZ IAS 38 PBE p.112). This would give rise to a loss on disposal in the income statement.
- Provided the FPSC project is not discontinued in its entirety, some assets would remain following the above. However, the re-scoping of the project would result in revised costs to complete and a revised (and presumably lower) level of benefits or service potential. This would be an impairment indicator. A revised DRC would need to be determined based on the optimised cost of delivering the re-scoped project. If this is lower than the carrying amount of the remaining assets, an impairment loss should be recognised in the income statement.

In our view, the DHB's intangible asset would be similarly affected and would need to be tested for impairment based on a revised DRC for the re-scoped project (and taking into account each DHB's proportionate funding of that re-scoped project).

Any impairment loss would reflect the fact that if the project had originally been scoped to deliver the revised (and presumably lower) level of benefits or service potential, it would have cost less from the start i.e. the DHBs funding would have been lower.

Disclosure

This is a very significant project for HBL and the DHBs, the outcome of which is currently uncertain.

The current uncertainty regarding the future of the FPSC project necessitates the need for management to exercise judgement regarding the most likely outcome of the project and the consequences of that for the recoverable amount of the FPSC assets/DHB intangible assets recognised at 30 June 2014.

We therefore recommend comprehensive disclosure of management's impairment considerations including the basis on which recoverable amount of the assets has been determined, the key assumptions on which management has based its determination of DRC and the uncertainties regarding the outcome of the FPSC project.

Transition to PBE Standards from 1 July 2014

HBL and the DHBs will transition to PBE Standards based on IPSAS for periods beginning on or after 1 July 2014 i.e. for their 30 June 2015 year end onwards.

PBE IPSAS 21 has similar requirements to NZ IAS 36 PBE. Under PBE IPSAS 21, an asset is impaired when its carrying amount exceeds its recoverable service amount, being the higher of fair value less costs to sell and value in use. The value in use of a non-cash generating asset is the present value of the asset's remaining service potential, which may be determined using a DRC approach (as outlined above), a restoration cost approach or a service units approach. The merits of either of these latter approaches for testing the FPSC software assets under development, the DHBs' indefinite life intangible assets and any other assets that required testing for impairment, should be assessed when this standard becomes applicable.

Appendix B

Scope of opinion

This engagement has been performed in accordance with the Institute of Chartered Accountants of New Zealand's Advisory Engagement Standard No.1: *Opinions on Accounting and Reporting Matters* and our letter of engagement and terms of business dated 9 July 2013.

Our opinion is based primarily upon discussions with management of Health Benefits Limited. Our opinion is based on the following documents and assumptions;

Documents:

- Information Paper: "FPSC Programme Options Review" dated 11 June 2014.

Assumptions:

- The costs capitalised to date by HBL and the DHBs met the criteria for recognition in NZ IAS 16 PBE and NZ IAS 38 PBE at the point they were incurred.
- The 'best estimate' of HBL's and the DHBs' management at 30 June 2014 is that the FPSC project will proceed and that funds will be made available by the Crown.

In considering the matters on which we have expressed an opinion, we have made reference to the following pronouncements:

- NZ IAS 10 (PBE): *Events after the Reporting Period* ('NZ IAS 10 PBE');
- NZ IAS 16 (PBE): *Property, Plant and Equipment* ('NZ IAS 16 PBE');
- NZ IAS 36 (PBE): *Impairment of Assets* ('NZ IAS 36 PBE');
- NZ IAS 38 (PBE): *Intangible Assets* ('NZ IAS 38 PBE');
- PBE IPSAS 21: *Impairment of non-cash-generating assets* ('PBE IPSAS 21')

We have assumed for the purposes of this letter that there are no other restrictions, agreements or arrangements that would be relevant to the issue that we are not aware of.

If there is any change in the assumptions upon which our opinion is based, the circumstances in which this opinion is given or the pronouncements upon which we have relied in forming our opinion, we recommend that you consult again with us to ensure our opinion continues to be appropriate and valid.

In our opinion we are not commenting on the commercial, credit, taxation, reputational or other desirability of the transaction. We have not reviewed any of the relevant documentation from a taxation or legal viewpoint, as we consider that such a review would be more appropriately performed by your tax and legal advisers.