ASSURANCE ALERT

IMPACTS OF TRANSITIONING FROM DIFFERENTIAL REPORTING TO NZ IFRS REDUCED DISCLOSURE REGIME: (3) REQUIREMENT TO PREPARE A STATEMENT OF CASH FLOWS

As highlighted in the December 2014 edition of Assurance Alert, there are a number of key differences for entities to consider when transitioning from the NZ IFRS differential reporting regime (Tier 3) to the NZ IFRS Reduced Disclosure Regime (Tier 2).

In this article we will be addressing the impact of the removal of the option for entities not to prepare a statement of cash flows

Overview of the requirements of NZ IFRS (Diff Rep) and NZ IFRS (RDR)

Paragraph NZ 1.1 of NZ IAS 7 (Diff Rep) *Cash and Cash Equivalents* provides entities with the option not to prepare a statement of cash flows.

Under NZ IFRS (RDR) this option has been removed, and therefore Tier 3 entities that will be required to transition to Tier 2 that have previously utilised this option[1] will need to prepare a statement of cash flows, which requires cash flows relating to operating, investing, and financing activities to be presented by using either one of two methods:

- Direct method – grouped by classes of gross cash flows (Note that FRS-44 *New Zealand Additional Disclosures* requires a reconciliation of net operating cash flows to accounting profit to be presented in addition)
- Indirect method – where by cash flows from operating activities is reconcile to accounting profit by making adjustments for non-cash expenditure and movements in working capital items, followed by cash flows from investing and financing activity grouped by classes of gross cash flows

Previously only the direct method was permitted in NZ GAAP, however the amendments to harmonise New Zealand and Australian accounting standards in 2011 re-introduced the indirect method option into NZ IAS 7.

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Operating activities are the principal revenue-producing activities of the entity and the default category for any other cash flows that are not investing or financing activities.

Investing activities are those related to the acquisition and disposal of long-term assets and other investments.

Financing activities are those that result in changes in the size and composition of the contributed equity and borrowings of the entity.

[1]Some Tier 3 entities may have opted not to utilise this option for various reasons, including (but not limited to) that they may be part of a consolidated group is unable to apply, or opts not to apply, this option (i.e. those groups that are themselves Tier 1 reporters)

Statement of cash flows – key points

The statement of cash flows is a stand-alone financial statement that presents the gross movement of actual cash flows of the entity during the period. Therefore in some aspects it should not reconcile to the other primary financial statements and notes for the same line item.

For example, consider interest paid by an entity during a period. The amount presented in the statement of cash flows should be different to the amount presented elsewhere in the financial statements due to:

- Interest expense in the statement of comprehensive income being recognised using the effective interest method (not on a cash paid basis)
- Capitalisation of some interest to qualifying assets in the statement of financial position.

Also, NZ IAS 7 prescribes guidance and requirements in relation to several specific cash flows and other requirements. These are summarised in the table opposite:

GUIDANCE AND/OR REQUIREMENT	DESCRIPTION
Examples of *operating activities*	Refer NZ IAS 7 paragraph 14 and 15.
Examples of investing activities	Refer NZ IAS 7 paragraph 16, notable inclusions are: ▶ Cash flows from the purchase/sale of derivatives that are not held for dealing or trading purposes. ▶ Cash flows from the purchase/sale of equity and debt instruments in other entities that are not held for dealing or trading purposes (i.e. those categorised as Available for Sale financial assets).
Examples of *financing activities*	Refer NZ IAS 7 paragraph 17.
Presentation of cash flows on a net basis	Refer NZ IAS 7 paragraph 22 – 24. By and large, all cash flows must be presented on a gross basis, with no offset. For example, an entity must present the gross amounts regarding drawn downs and principal repayments separately for loans advanced from a third party (i.e. bank). The entity is **not permitted** to present the net effect in a single line. There are however a few instances where presentation on a net basis is permitted: ▶ The cash receipts and payments are on behalf of the entity's customers and reflect the customer's activities (e.g. customer funds held by an investment entity). ▶ The cash receipts and payments are large amounts relating to items where maturities are short and turnover is quick (purchase and sale of investments). ▶ Specific cash flows relating to financial institutions.
Foreign currency cash flows (FCCFs)	Refer NZ IAS 7 paragraph 25 – 28. FCCFs must be recorded in the entity's function currency at the exchange rate on the date of the cash flow: ▶ For transactions in a foreign currency ▶ For transactions of a foreign subsidiary. Where foreign cash balances are held, a reconciling line item between opening and closing cash balances will be required to presented to reflect the change in exchange rates during the period.
Interest and dividends	Refer NZ IAS 7 paragraph 31 – 34. Cash inflows and outflows from both interest and dividends must be presented separately. They can be presented as either *operating*, *investing*, or *financing activities* (must be consistent period-to-period).
Taxes on income	Refer NZ IAS 7 paragraph 35 – 36. Must be presented separately within operating activities (unless they can be specifically identified with investing or financing activities).

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What should effected entities be doing now?

While the transition to and adoption of NZ IFRS (RDR) may appear to be far into the future, entities should not underestimate the complexities and the significant time, cost, and expertise that is required in order to properly compile the required cash flow information in order to prepare the statement of cash flows.

At a minimum, effected entities will need to begin to:

- Determine which cash flow presentation method they will adopt
- Determine what their key *operating*, *investing*, and *financing activities* are
- Whether they will meet any of the criteria to present cash flows on a net basis
- The impact of foreign currency cash flows
- Determine the classification of cash flows from interest and dividends
- Identify non-cash transactions that **should not** appear in the statement of cash flows
- What makes up the components of the entity's closing cash balance in the statement of cash flows
- Determine whether any of the entity's cash balances are restricted.

- **For more information on the above, please contact your local BDO**

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GUIDANCE AND/OR REQUIREMENT	DESCRIPTION
Investments in subsidiaries, associates and joint ventures	Refer NZ IAS 7 paragraph 37 – 38. Where these investments are accounted for at cost or the equity method, cash flows to be presented are only those between the entity and the investee (e.g. dividends). Cash flows from equity method accounted associates and joint ventures are presented separately.
Changes in ownership interest in subsidiaries and other businesses	Refer NZ IAS 7 paragraph 39 – 42B Cash flows are presented within investing activities. The amount present is the amount of cash paid less any amounts of cash acquired (i.e. in a business combination where the entity acquires the acquirees cash-on-hand and bank account)
Non-cash transactions	Refer NZ IAS 7 paragraph 43 - 44 Non-cash transactions **are not** presented in the statement of cash flows.
Components of cash and cash equivalents	Refer NZ IAS 7 paragraph 45 – 47. An entity must reconcile the closing amount of cash presented in the statement of cash flows to the equivalent items in the statement of financial position.
Restricted cash balances	Refer NZ IAS 7 paragraph 48 - 51 An entity must disclose details regarding significant cash balances that are not available for use by the group (e.g. cash held by a subsidiary in a foreign jurisdiction which has exchange controls or legal restrictions on the movement of cash).

NZ IFRS 15 – REVENUE RECOGNITION TO CHANGE FOR THE CONSTRUCTION INDUSTRY

This month we take a close look at the impacts on the construction industry of NZ IFRS 15 *Revenue from Contracts with Customers*. NZ IFRS 15 will apply to Tier 1 and Tier 2 for-profit entities for annual periods commencing on or after 1 January 2017.

For entities in the construction industry, NZ IFRS 15 can significantly change the pattern of revenue and profit recognition, as well as affect bank covenants, performance-based compensation (including bonuses and share-based payments), internal budgeting processes, and market and investor communications.

NZ IFRS 15 contains more specific guidance on revenue recognition than the current NZ IAS 18 *Revenue* and NZ IAS II *Construction Contracts* standards.

The following areas within the construction industry are likely to be impacted under NZ IFRS 15:

- Installing a specific piece of large equipment/machinery
- Mobilisation fees
- Performance penalties/bonuses
- Design and build contracts
- Contracts with significant payments in advance.

Installing a specific piece of large equipment/machinery

While NZ IFRS 15 allows revenue to be based on the proportion of costs incurred to date ('costs incurred to date' model), which is similar to the 'percentage of completion' method under NZ IAS 11, it does potentially differ significantly in respect of the pattern of profit recognition when the construction contract involves the installation of large pieces of specific equipment or machinery (e.g. lifts, turbines, engines, etc.), which have a significant cost.

NZ IFRS 15 requires that the cost of the equipment/machinery be excluded from the 'costs incurred to date' model when determining the profit recognised, because that cost is not indicative of the progress of the construction activity. When such material is installed and control passes, revenue is only recognised to the extent of the costs of the materials installed and no profit margin is recognised.

Under NZ IAS 18, revenue and profit margin is typically recognised when the equipment is installed as part of the percentage of completion method.

In situations where large pieces of equipment are installed early on in the construction contract, NZ IFRS 15 will most likely delay the recognition of revenue, and therefore profit, compared with current practice under NZ IAS 11.

Mobilisation fees

Mobilisation fees, such as recruiting teams and building capacity to fulfil the contract are also excluded from the 'costs incurred to date' model. As the customer has not received a benefit from 'mobilisation', this does not represent revenue under NZ IFRS 15.

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Any fees received from the customer associated with this mobilisation are not separately recognised as revenue, but are recognised as part of the total contract price and therefore recognised over the period of the contract.

Costs in relation to mobilisation activities may be capitalised and amortised over the period of the construction contract.

Performance penalties and bonuses

Penalty payments often apply when a project is not completed on time. Similarly, when a project is completed on time, or earlier than the agreed date, performance bonuses may also apply. Penalty payments and performance bonuses are variable consideration under NZ IFRS 15.

Compared to NZ IAS 18, NZ IFRS 15 contains more detailed guidance on variable consideration. Under NZ IFRS 15, variable consideration must be estimated using one of these two methods:

- Expected value method – this method involves adding up the probability-weighted amounts in the range of the total possible consideration, or
- Mostly likely value method – this method involves choosing the single most likely amount from a range of possibilities. This would be appropriate where there are say only two possible outcomes.

The method used should be the one that is expected to better predict the outcome. The estimate needs to be updated every reporting period. When estimating variable consideration, NZ IFRS 15 requires the application of 'constraint' and recognise variable consideration as revenue 'only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur'.

'Design and build' contracts

It is not uncommon to enter into separate contracts with a customer, one for design work, and the other for construction. NZ IFRS 15 contains significantly more guidance when accounting for contracts that are not 'distinct' from another contract. 'Design and build' contracts are likely to be accounted for as one performance obligation under NZ IFRS 15, rather than two separate contracts. This means that 'design' revenue will be recognised over the period of the 'design and build' performance obligation, rather than on completion of the 'design' contract.

Contracts with significant advance payment terms

Under NZ IFRS 15, the amount of revenue recognised on construction contracts with significant advance payments terms is likely to be higher than the agreed contract price. The advanced payment from the customer represents a borrowing cost, which has effectively been netted off the amount received from the customer. Revenue recognised under NZ IFRS 15 would effectively be 'grossed up' by the amount of interest expense (being the amount 'borrowed' from the customer to fund construction). It is likely that the borrowing cost would qualify for capitalisation if the asset under construction is a qualifying asset under NZ IAS 23 *Borrowing Costs*.

Example 1

1 June 2018

- Builder Co enters into a contract to refurbish an old building and install a lift for $5,000,000
- Refurbishment work is to be completed by 30 June 2019. If the refurbishment is not completed on time there will be a $100,000 penalty for each week that Builder Co is late
- Builder Co estimates total costs for the project to be $4,000,000
  - Lift cost: $1,500,000
  - Other refurbishment costs, including installation costs of the lift ('refurbishment costs'): $2,500,000.

Based on the facts above and details of progress below, how should Builder Co recognise revenue and profit at 30 June 2018, 31 December 2018, 30 June 2019, 31 December 2019 and 30 June 2020?

30 June 2018

- Only the lift is delivered.

Builder Co recognises revenue of $1,500,000 and costs of $1,500,000 when the lift is delivered on site. The cost of the lift is not indicative of the progress of Builder Co's refurbishment activity that it has promised to perform, so it **does not** recognise any profit when the lift is delivered.

	30 june 2018
Revenue	$1,500,000
Costs	$1,500,000
Net profit	**$0**

The contract contains penalty payment clauses which is a form of variable consideration. Builder Co would need to estimate the transaction price. Assume that Builder Co uses the expected value method and estimates the following probabilities:

Estimated Completion Date	Probability	Probability-Weighted Consideration
On time	50%	$2,500,000 ($5,000,000 x 50%)
One week late	30%	$1,470,000 ($4,900,000 x 30%)
Two weeks late	20%	$960,000 ($4,800,000 x 20%)
Transaction price		**$4,930,000**

- $1,000,000 of the other $2,500,000 refurbishment costs have been incurred.

Builder Co updates its estimates of the transaction price as follows:

Estimated Completion Date	Probability	Probability-Weighted Consideration
On time	60%	$3,500,000 ($5,000,000 x 60%)
One week late	30%	$1,470,000 ($4,900,000 x 30%)
Two weeks late	10%	$480,000 ($4,800,000 x 10%)
Transaction price		**$4,950,000**

Refurbishment costs incurred to date is 40% ($1,000,000 / $2,500,000). Transaction price allocated to the refurbishment is $3,450,000 ($4,950,000 - $1,500,000).

Transaction price	$4,950,000
Less: Price allocated to lift	($1,500,000)
Price allocated to refurbishment	$3,450,000
% cost incurred to date	40%
Refurbishment revenue to date	**$1,380,000**

	30 June 2018	31 December 2018	Total to date
Revenue	$1,500,000	$1,380,000	$2,880.000
Costs	$1,500,000	$1,000,000	$2,500,000
Net Profit	$0	$380,000	$380,000
Profit %	Nil	**27.5%**	**23.2%**

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30 June 2019

- The owner of the building now wants Builder Co to make additional refurbishments to make the building more energy efficient
- Total contract price increased to $7,000,000
- Total estimated costs increased to $5,500,000, being:
- Lift cost: $1,500,000
- Solar panels: $1,000,000
- Other refurbishment costs (including lift and solar panel installation): $3,000,000
- Other refurbishment costs incurred to date is $2,000,000
- The completion date is extended to 10 February 2020
- The same penalty will apply if refurbishment is not completed on time
- In addition, the owner wants to add a swimming pool and a landscaped garden. The price agreed for this particular piece of work is $500,000.

The additional refurbishments to make the building more energy efficient are highly interrelated with the original refurbishments. The additional refurbishments are accounted for as a contract modification of the original contract.

The additional swimming pool and landscaped garden can be argued to be 'distinct' i.e. separate from the promise to refurbish the building. If $500,000 is the stand alone selling price, then it is treated as a separate contract, and revenue is recognised separately. If $500,000 is not the stand alone selling price (e.g. a discount is offered) then the additional swimming pool and landscaped garden also need to be included within the original contract as a contract modification. (For the purposes of the rest of this illustration, only the accounting for the modified refurbishment contract is considered. The accounting for the swimming pool and landscape which is considered to be a separate contract is not further illustrated.)

Builder Co updates its estimates of the transaction price at 30 June 2019, taking into account the additional refurbishment required, its progress completed to date, and the fact that Builder Co has never performed the energy efficient related refurbishments before.

Estimated Completion Date	Probability	Probability-Weighted Consideration
On time	20%	$1,400,000 ($7,000,000 x 20%)
One week late	40%	$2,760,000 ($6,900,000 x 40%)
Two weeks late	40%	$2,720,000 ($6,800,000 x 40%)
Transaction price		**$6,880,000**

Transaction price allocated to the refurbishment is $4,380,000 ($6,880,000 - $2,500,000).

Refurbishment costs incurred to date is 66.67% ($2,000,000/$3,000,000).

Transaction price	$6,880,000
Less: Price allocated to lift & solar panels	($2,500,000)
Price allocated to refurbishment	$4,380,000
% cost incurred to date	66.67%
Revenue to date on refurbishment	$2,920,000
Revenue recognised in prior periods for refurbishment	$1,380,000
Refurbishment revenue for the period	**$1,540,000**

31 December 2019

- Builder Co has completed all the major refurbishments other than the installation of the solar panels.

Builder Co estimates that there is a 100% probability that the refurbishment will be completed on time, so the estimated transaction price is $7,000,000.

Transaction price	$7,000,000
Less: Price allocated to lift & solar panels	($2,500,000)
Price allocated to refurbishment	$4,500,000
% cost incurred to date	100%
Revenue to date on refurbishment	**$4,500,000**
Revenue recognised in prior periods for refurbishment	**$2,920,000**
Refurbishment revenue for the period	**$1,580,000**

	30 June 2018	31 December 2018	30 June 2019	31 December 2019	Total to date
Revenue	$1,500,000	$1,380,000	$1,540,000	$1,580,000	$6,000,000
Costs	$1,500,000	$1,000,000	$1,000,000	$1,000,000	$4,500,000
Net Profit	$0	$380,000	$540,000	$580,000	$1,500,000
Profit %	**Nil**	**27.5%**	**35.1%**	**36.7%**	**25%**

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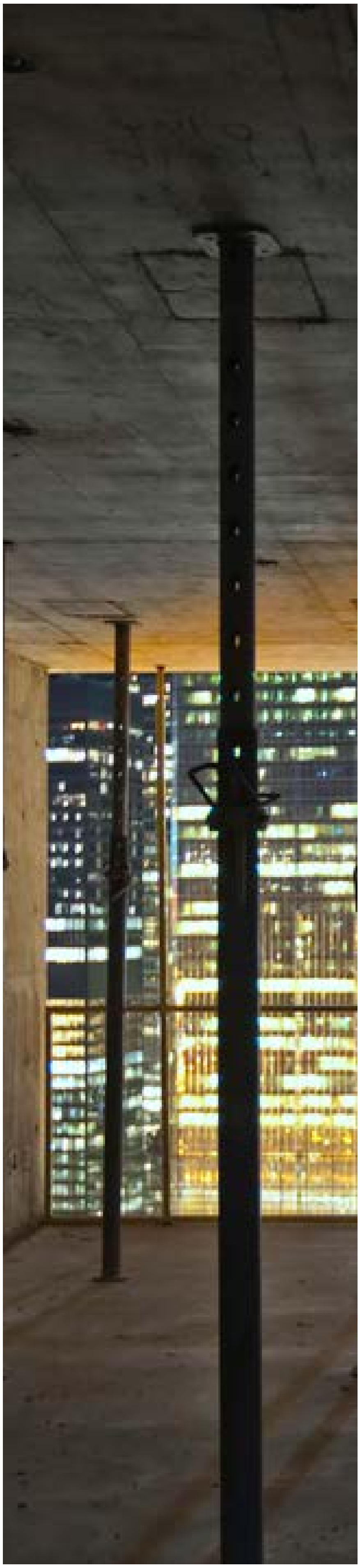

10 February 2020

- The solar panels were delivered and installed
- The refurbishment project was completed on time and accepted by the owner.

Builder Co recognises revenue of $1,000,000 and costs of $1,000,000. The cost of the solar panels is not indicative of the progress of Builder Co's refurbishment activity that it has promised to perform so it does not recognise any profit on the solar panels.

Builder Co recognises revenue of $1,000,000 and costs of $1,000,000. The cost of the solar panels is not indicative of the progress of Builder Co's refurbishment activity that it has promised to perform so it does not recognise any profit on the solar panels.

	30 June 2018	31 December 2018	30 June 2019	31 December 2019	30 june 2020	Total to date
Revenue	$1,500,000	$1,380,000	$1,540,000	$1,580,000	1,000,000	$7,000,000
Costs	$1,500,000	$1,000,000	$1,000,000	$1,000,000	1,000,000	$5,500,000
Net Profit	$0	$380,000	$540,000	$580,000	$0	$1,500,000
Profit %	**Nil**	**27.5%**	**35.1%**	**36.7%**	**Nil**	**21.4%**

Summary

The following two tables summarise the revenue and profit recognised for each of the reporting periods under NZ IAS 18 *Revenue* and the new NZ IFRS 15 standard. The results demonstrate how the pattern of revenue and profit recognition changes significantly under NZ IFRS 15. Refer to Appendix A on page 8 for detailed calculations.

NZ IAS 18 Revenue	30 June 2018	31 December 2018	30 June 2019	31 December 2019	30 june 2020	Total
Revenue for the period	$1,875,000	$1,250,000	$1,329,545	$1,272,727	$1,272,727	$7,000,000
Costs for the period	$1,500,000	$1,000,000	$1,000,000	$1,000,000	1,000,000	$5,500,000
Profit for the period	$375,000	$250,000	$329,545	$272,727	$272,727	$1,500,000
Profit %	**20%**	**20%**	**24.8%**	**21.4%**	**21.4%**	**21.4%**

NZ IFRS 15 Revenue	30 June 2018	31 December 2018	30 June 2019	31 December 2019	30 june 2020	Total
Revenue for the period	$1,500,000	$1,380,000	$1,540,000	$1,580,000	1,000,000	$7,000,000
Costs for the period	$1,500,000	$1,000,000	$1,000,000	$1,000,000	1,000,000	$5,500,000
Profit for the period	$0	$380,000	$540,000	$580,000	$0	$1,500,000
Profit %	**Nil**	**27.5%**	**35.1%**	**36.7%**	**Nil**	**21.4%**

Example 2

On 1 June 2018, Builder Co enters into a contract to refurbish an old building.

Builder Co charges the customer a mobilisation fee of $200,000 to set up site security, and bring in equipment and facilities such as a port-a-cabin and a port-a-loo for the construction workers.

The mobilisation cost to Builder Co is $150,000.

How should Builder Co recognise the mobilisation fee and the associated costs?

The customer has not received a benefit from 'mobilisation'. The $200,000 received from the customer is therefore not recognised separately as revenue on 1 June 2018, but is included in the transaction price, and recognised as revenue over the period of the construction contract as Builder Co performs its performance obligation. The mobilisation costs are capitalised and amortised over the period of the construction contract. Under NZ IFRS 15, this results in revenue and profit being deferred.

The journal entries under NZ IFRS 15 are as follows:

	Dr	Cr
Dr Contract Asset	**$150,000**	
Cr Cash		$150,000
	Dr	**Cr**
Dr Cash	**200,000**	
Cr Deferred Revenue		$200,000

It is not uncommon in practice under NZ IAS 18 today to account for the mobilisation fee separately from the construction contract.

1 June 2018

Profit or loss

	NZ IAS 18	NZ IFRS 15
Revenue	$200,000	-
Costs	$150,000	-
Net profit	**$50,000**	**$-**

Statement of Financial Position

	NZ IAS 18	NZ IFRS 15
Revenue	$200,000	-
Costs	$150,000	-
Net profit	**$50,000**	**$-**

Example 3

On 1 January 2018, Construction Co enters into two contracts, one to design, and the other to build, a factory.

	Fee	Cost
Design	$1,000,000	$500,000
Construction	$2,000,000	$1,500,000
Total	**$3,000,000**	**$2,000,000**

The design stage is completed by 30 June 2018 and the construction of the factory is completed by 30 June 2019.

How should Construction Co recognise revenue at 30 June 2018 and 2019?

Because the two elements of the contract are highly interrelated, the two elements are treated as one performance obligation. Assuming the project does not involve installing a specific piece of large equipment/machinery, under the 'costs incurred to date' model in NZ IFRS 15, Construction Co would recognise 25% of the revenue ($500,000/$2,000,000) at 30 June 2018.

It is not uncommon in practice under NZ IAS 18 today to account for the two elements separately.

30 June 2018

	NZ IAS 18	NZ IFRS 15
Revenue	$1,000,000	$750,000
Costs	$500,000	$500,000
Net profit	**$500,000**	**$250,000**

30 June 2019

	NZ IAS 18	NZ IFRS 15
Revenue	$2,000,000	$2,250,000
Costs	$1,500,000	$1,500,000
Net profit	**$500,000**	**$750,000**

Practical implications

The impacts of NZ IFRS 15 are not only the significant changes in the patterns of revenue and profit recognition as the above examples have shown. Systems and processes will also have to change to deduct the costs of significant equipment/material and mobilisation costs in calculating % of progress to date. Entities in the construction industry will also need to think about how to account for penalties and performance bonus payments in construction contracts, as well as its policy and processes for estimating the expected or most likely value, and revising the estimate at each reporting date.

► **For more on the above, please contact your local BDO representative.**

APPENDIX A

The following two tables summarise the revenue and profit recognised in Example 1 for each of the reporting periods under NZ IAS 18 Revenue and the new NZ IFRS 15 standard.

NZ IAS 18 Revenue	30 June 2018	31 December 2018	30 June 2019	31 December 2019	30 June 2020	Total
Contract price	$5,000.000	$5,000.000	$7,000.000	$7,000.000	$7,000.000	
Costs incurred this period	$1,500,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	
Costs incurred to date	$1,500,000	$2,500,000	$3,500,000	$4,500,000	$5,500,000	
Total estimated contract costs	$4,000,000	$4,000,000	$3,500,000	$4,500,000	$5,500,000	
Stage of completion	37.5%	62.5%	63.64%	81.82%	100%	
Revenue to date	$1,875,000	$3,125,000	$4,454,545	$5,727,273	$7,000,000	
Revenue recognised in prior periods	$0	$1,875,000	$3,125,000	$4,454,545	$5,727,273	
Revenue for the period	**$1,875,000**	**$1,250,000**	**$1,329,545**	**$1,272,727**	**$1,272,727**	**$7,000,000**
Costs for the period	**$1,500,000**	**$1,000,000**	**$1,000,000**	**$1,000,000**	**$1,000,000**	**$5,500,000**
Profit for the period	**$375,000**	**$250,000**	**$329,545**	**$272,727**	**$272,727**	**$1,500,000**

NZ IAS 15 Revenue	30 June 2018	31 December 2018	30 June 2019	31 December 2019	30 June 2020	Total
Contract price	$4,930.000	$4,950.000	$6,880.000	$7,000.000	$7,000.000	
Uninstalled materials						
Contract price allocated to uninstalled materials	$1,500,000	$1,500,000	$2,500,000	$2,500,000	$2,500,000	
Costs of uninstalled materials incurred this period	$1,500,000	$0	$0	$0	$1,000,000	
Revenue for the period	$1,500,000	$0	$0	$0	$1,000,000	
Refurbishment						
Contract price allocated to refurbishment	$3,430,000	$3,450,000	$4,380,000	$4,500,000	$4,500,000	
Refurbishment costs incurred this period	$0	$1,000,000	$1,000,000	$1,000,000	$0	
Refurbishment costs incurred to date	**$0**	**$1,000,000**	**$2,000,000**	**$3,000,000**	**$3,000,000**	
Total estimated refurbishment costs	**$2,500,000**	**$2,500,000**	**$3,000,000**	**$3,000,000**	**$3,000,000**	
% of costs incurred to date	0.00%	40%	66.67%	100%	100%	
Revenue to date for refurbishment	$0	$1,380,000	$2,920,000	$4,500,000	$4,500,000	
Revenue recognised in prior periods for refurbishment	$0	$0	$1,380,000	$2,920,000	$4,500,000	
Revenue for the period for refurbishment	$0	$1,380,000	$1,540,000	$1,580,000	$0	
	$0	$1,875,000	$3,125,000	$4,454,545	$5,727,273	
Total revenue for the period	**$1,500,000**	**$1,380,000**	**$1,540,000**	**$1,580,000**	**$1,000,000**	**$7,000,000**
Total costs for the period	**$1,500,000**	**$1,000,000**	**$1,000,000**	**$1,000,000**	**$1,000,000**	**$5,500,000**
Profit for the period	**$0**	**$380,000**	**$540,000**	**$580,000**	**$0**	**$1,500,000**

FINANCIAL INSTRUMENTS – CHANGES TO CLASSIFICATION AND MEASUREMENT

In September 2014 the New Zealand Accounting Standards Board (NZASB) issued NZ IFRS 9 *Financial Instruments* (2014) which incorporates the final requirements of all three phases of the financial instruments project – classification and measurement, impairment and hedge accounting.

NZ IFRS 9 will be applicable to Tier 1 and Tier 2 for-profit entities for annual periods commencing on or after 1 January 2018, with relatively complex early adoption provisions.

The 2014 version of NZ IFRS 9 adds the following to the existing NZ IFRS 9:

- New impairment requirements for all financial assets that are not measured at fair value through profit or loss (including receivables)
- Amendments to the previously finalised classification and measurement requirements.

In the September 2014 edition of Assurance Alert, we focused on the new impairment requirements for financial assets. This month, we will focus on the revised classification and measurement requirements.

Implications

The introduction of the 'fair value through other comprehensive income' (FVTOCI) category may result in less profit or loss volatility than the previous version of NZ IFRS 9, for example, when you hold a government or a corporate bond that is collecting interest income, but you may also have the intention to sell the asset at any time before maturity.

New measurement category

Under the previous version of NZ IFRS 9, debt investments are classified at either amortised cost or fair value through profit or loss. Amortised cost is used if both of the following criteria are met:

- The contractual terms of the investment give rise to cash flows that are solely payments of principal and interest (SPPI test) (interest being compensation for credit and time value of money) - i.e. the instrument only pays 'pure' interest cash flows that you expect from a basic lending relationship, and
- The investment is held with the objective of collecting the contractual cash flows.

Fair value is used where:

- Amortised cost is not applicable, or
- If doing so eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch).

NZ IFRS 9 (2014) adds an additional measurement category for financial assets that are debt instruments, i.e. FVTOCI. This new measurement category is more likely to apply to debt instruments such as investments in government or corporate bonds.

To qualify for this category, the debt investment:

- Must meet the SPPI contractual cash flow characteristics test, and
- Must be held to both collect the contractual cash flows as well as with a view to sell the investment.

Example 1

Entity A sold one of its diverse business operations and currently has $10 million cash. It has not yet found another suitable investment opportunity, so it invests in a portfolio of government bonds to collect interest. The portfolio of government bonds matures in 12 months' time. Once a suitable business investment opportunity arises, Entity A intends to sell the bonds and use the proceeds for the acquisition of a business operation.

How should Entity A classify this investment?

Classification depends on when management expects a suitable business investment opportunity to be found.

Length of time a suitable business investment opportunity is likely to be found	Business objective/s under IFRS 9	Measurement category
Within 12 Months	• Collect contractual cash flows, and • Sell the bond	FVTOCI
More than 12 months	• Collect the contractual cash flow	Amortised cost

The accounting mechanics for this new measurement category requires calculation of the asset's amortised cost (including impairment) and fair value and it is quite complex. The mechanics are as follows:

- Recognise interest revenue in profit or loss using the effective interest method (as for financial assets measured at amortised cost)
- Recognise credit impairment losses/reversals in profit or loss using the same credit impairment methodology as for financial assets measured at amortised cost
- Recognise the cumulative fair value gain or loss in OCI and recycle the gain or loss to profit or loss when the debt instrument is derecognised.

Example 2

On 1 January 2018, a government bond is purchased at its face value of $1,000. Contractual term is 10 years, coupon 5%. Expected credit losses as determined under the impairment model are $20.

Journal entries as follows

	Dr	Cr
Dr Financial Asset	**$1,000**	
Cr Cash		$1,000
Dr Impairment loss (P&L)	**$20**	
Cr OCI		**$20**

Balance Sheet:	
Financial Asset	**$1,000**
Allowance Account	($20)
Accumulated OCI (equity)	**$20**
Profit or loss:	
Impairment loss	**($20)**

Continued on next page.

On 31 December 2018, fair value decreased to $950. Expected losses increased to $30. A coupon payment of $50 ($1,000 X 5%) is received.

	Dr	Cr
Dr Cash (5% x $1,000)	**$50**	
Cr Interest revenue		**$50**
Dr Impairment loss (P&L) ($30 - $20)	**$10**	
Dr OCI ($50-$10)	**$40**	
Cr Financial Asset ($1,000 - $950)		**$50**

Balance Sheet:	
Financial Asset	**$950**
Allowance Account	($30)
Accumulated OCI (equity)	**($20)**
Profit or loss:	
Impairment loss	**($10)**

On 1 January 2019 the financial asset is sold for $950.

	Dr	Cr
Dr Cash (5% x $1,000)	**$950**	
Cr Financial Asset		$950
Dr Loss on sale (P&L)	**$20**	
Cr OCI		**$20**

Other changes

In other changes, NZ IFRS 9 (2014) clarifies some application issues in relating to the SPPI contractual cash flow test:

- Although the most significant elements of interest under the SPPI test are time value of money and credit risk, interest can also contain other elements such as liquidity risk, profit margin, and service or administrative costs
- For a floating rate debt investment where the frequency of interest rate reset does not match the maturity of the instrument (for example, certain Japanese government bonds have a semi-annual interest rate reset but the rate is always reset to a 10 year rate regardless of maturity (known as Japanese 10 year constant maturity bonds)), the investment can still meet the SPPI test if the modified cash flows (i.e. 10 year rate) are not significantly different from a benchmark investment (i.e. investment that resets to a 6 month rate) - however 'significantly different' is not defined
- For investments in jurisdictions where the interest is regulated by the government e.g. China, the investment may still meet the SPPI test if that regulated interest rate provides consideration that is broadly consistent with the passage of time

- **For more on the above, please contact your local BDO representative.**

NEW BDO PUBLICATIONS

The **Audit** section of our website (www.bdo.co.nz/audit) includes a range of publications on IFRS issues. For example:

- **NZ IFRS Industry Issues** contains a high level overview of the impact of new standards on particular industries. Recent NZ IFRS Industry Issues include overviews of the impact of NZ IFRS 15 *Revenue from Contacts with Customers* on the manufacturing; retail; telecommunications, software; media, construction-real estate and professional services industries.
- **Summaries on a Page** (SOAPs)contain summaries of NZ IFRS Standards for for-profit entities and PBE Standards for public sector and not-for profit entities currently in effect in New Zealand.

Also look for the **'BDO International IFRS'** link which includes resources such as:

- **IFRS at a glance** – 'one page' and short summaries of all IFRS standards.
- **IFRS News at a glance** – provides high-level headlines of newly released documents by the IASB and IFRS related announcements by securities regulators.
- **Need to Knows** – updates on major IASB projects and highlights practical implications of forthcoming changes to accounting standards. Recent Need to Knows include IFRS 9 *Financial Instruments - Impairment of Financial Assets* (Dec 2014), IFRS 15 *Revenue from Contracts with Customers* (Aug 2014), IFRS 9 *Financial Instruments* (May 2014), *Hedge Accounting* (IFRS 9 Financial Instruments) (Jan 2014), IFRS 11 *Joint Arrangements* (Dec 2013) and IFRS 13 *Fair Value Measurement* (Dec 2013).
- **IFRS in Practice** – practical information about the application of key aspects of IFRS, including industry specific guidance. Recent IFRS in Practice include IFRS 15 *Revenue from Contracts with Customers* (Oct 2014), IAS 7 Statement of Cash Flows, Distinguishing between a *business combination and an asset purchase in the extractives industry* (March 2014), IAS 36 *Impairment of Assets* (Dec 2013) and *Common Errors in Financial Statements – Share-based Payment* (Dec 2013).
- **Comment letters on IFRS standard setting** – includes BDO comments on various projects of international standard setters, including Exposure Drafts and other Discussion Papers, when it is considered that the issue is significant to the BDO network and its clients. Latest comment letters include IASB ED 2014-02 *Investment Entities: Applying the Consolidation Exception*, IASB ED 2014-01 *Disclosure Initiative and Request for information – Post-implementation Review*: IFRS 3 *Business Combinations*.

- **For more on the above, please contact your local BDO representative.**

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