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ACCOUNTING NEWS

ATTENTION DIRECTORS – ASX CORPORATE GOVERNANCE CHANGES – PART 4

THE 'IF NOT, WHY NOT' APPROACH

*'Security holders are unlikely to find brief statements – such as 'the recommendation is not considered appropriate, given the entity's size and circumstances' or, in the case of those recommendations suggesting that an entity has an audit, risk, nomination or remuneration committee, that 'the board as a whole performs the role that such a committee would ordinarily undertake' – to be particularly helpful in understanding why an entity has chosen not to follow a particular recommendation or what alternative corporate governance arrangements the entity may have instituted to address the underlying principle to which that recommendation is directed.'**

*From ASX Corporate Governance Principles and Recommendations (Third Edition), page 9

The ASX Corporate Governance Principles and Recommendations are based on the fundamental principle of disclosure on an 'if not, why not' basis. This allows boards to choose, and take full responsibility, for how they apply corporate governance. However, the 'if not, why not' basis **does** require disclosure where recommendations are not adopted.

In this month's article we remind directors of the requirements of the ASX Corporate Governance Principles and Recommendations for 'if not, why not' disclosure.

How the 'if not, why not' approach works

The ASX Corporate Governance Principles and Recommendations work on the basis that it is for the board of directors to determine which governance practices a listed entity should adopt. This is because the board is the body charged with the legal responsibility for managing the business with due care and diligence, and therefore for ensuring that it has appropriate governance arrangements in place.

Therefore, if the board considers that an ASX Corporate Governance Council Recommendation is not appropriate to its particular circumstances, it is entitled not to adopt it, but it must explain why it has not adopted the recommendation ('if not, why not' approach).

'Why not' disclosure

The ASX Corporate Governance Council considers that such 'why not' disclosure ensures that:

- Shareholders can have meaningful discussions with the board and management on governance matters
- Shareholders can use that information when deciding how to vote on particular resolutions, and
- Investors can use that information when deciding on whether to invest, or not to invest, in the entity's securities.

The 'if not, why not' approach is therefore fundamental to the operation of the ASX Corporate Governance Principles and Recommendations.

IN THIS EDITION

In this edition we continue our series on examining the practical implications of significant changes made to the ASX Corporate Governance Principles impacting listed entities from 1 July 2014, focussing on the 'if not, why not' disclosure requirements. We also look at impacts of the new revenue standard, IFRS 15 *Revenue from Contracts with Customers* on the construction industry from 1 January 2017, as well as further changes made by the International Accounting Standards Board to the classification and measurement requirements for financial instruments.

'Why not' disclosure must include reasons for non-compliance
When listed entities have not complied with a particular principle or recommendation, the Corporate Governance Statement required by ASX Listing Rule 4.10.3 must explain the board's **reasons** for not following a recommendation. These reasons should:

- Be detailed enough so that the market understands why the entity has chosen not to follow that recommendation, and
- Disclose what, if any, alternative corporate governance practices the entity has adopted instead, and why these alternative practices are more appropriate for the entity than the ones included in the recommendation.

Inadequate disclosure
As quoted above, security holders are unlikely to find brief statements such as the recommendation 'is not considered appropriate, given the entity's size and circumstances' to be a reasonable explanation as to why a particular recommendation is not being followed.

Instead, they would expect a description of the means by which the governance principle and recommendation is achieved.

For example, where an entity decides that the board does not use sub-committees (e.g. audit, risk, nomination, remuneration, etc.), a general statement such as 'The board as a whole performs the role that the committee would ordinarily undertake' is not sufficient. Instead, it must still disclose to how the key roles/functions of these committees is achieved by the board.

Next steps
The revised Third Edition of the ASX Corporate Governance Principles and Recommendations applies to listed entities for annual periods beginning on or after 1 July 2014. This means that the revised guidance applies to disclosure in the Corporate Governance Statement for your 30 June 2015 annual report. We encourage you to start reviewing these disclosures now to ensure that they comply with the new rules.

More information
Please refer to other articles in our Accounting News Corporate Governance series for more information:

Accounting News – August 2014 – Introduction to the changes to the Third Edition of ASX Corporate Governance Principles and Recommendations

Accounting News – September 2014 – Exposure to economic, environmental and social sustainability risks

Accounting News – October 2014 – Roles and responsibilities of directors with respect to financial reporting – Skills matrix and professional development requirements.

IFRS 15 – REVENUE RECOGNITION TO CHANGE FOR THE CONSTRUCTION INDUSTRY

THIS MONTH WE TAKE A CLOSER LOOK AT THE IMPACTS ON THE CONSTRUCTION INDUSTRY OF IFRS 15 *REVENUE FROM CONTRACTS WITH CUSTOMERS.*

For entities in the construction industry, 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.

IFRS 15 contains more specific guidance on revenue recognition than the current AASB 18 *Revenue* standard.

The following areas within the construction industry are likely to be impacted under 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.

The effective date of IFRS 15 is for annual reporting periods beginning on or after 1 January 2017. The Australian Accounting Standards Board is expected to approve and release the Australian equivalent standard (AASB 15) by the end of this year.

Installing a specific piece of large equipment/machinery
While 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 AASB 111 *Construction Contracts*, 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.

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 AASB 118, 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, IFRS 15 will most likely delay the recognition of revenue, and therefore profit, compared with current practice under AASB 111.

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 IFRS 15. 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 IFRS 15.

Compared to AASB 118, IFRS 15 contains more detailed guidance on variable consideration. Under 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, 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. 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 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 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 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 AASB 123 *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**

31 December 2018

- $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%	$3,000,000 ($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%**	**13.2%**

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 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 on refurbishment	$1,380,000
Refurbishment revenue for the period	**$1,540,000**

	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	TOTAL TO DATE
Revenue	$1,500,000	$1,380,000	$1,540,000	$4,420,000
Costs	$1,500,000	$1,000,000	$1,000,000	$3,500,000
Net profit	$0	$380,000	$540,000	$920,000
Profit %	**Nil**	**27.5%**	**35.1%**	**20.8%**

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 on 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%**

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.

	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	31 DECEMBER 2019	30 JUNE 2020	TOTAL
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 AASB 118 *Revenue* and the new IFRS 15 standard. The results demonstrate how the pattern of revenue and profit recognition changes significantly under IFRS 15. Refer to Appendix A on page 7 for detailed calculations.

AASB 118 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%**

IFRS 15 REVENUE	30 JUNE 2018	31 DECEMBER 2018	30 JUNE 2019	31 DECEMBER 2019	30 JUNE 2020	TOTAL
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**
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 IFRS 15, this results in revenue and profit being deferred.

The journal entries under 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 AASB 118 today to account for the mobilisation fee separately from the construction contract.

1 June 2018

Profit or loss

	AASB 118	IFRS 15
Revenue	$200,000	-
Costs	$150,000	-
Net profit	**$50,000**	**-**

Balance sheet

	AASB 118	IFRS 15
Contract asset	-	$150,000
Deferred revenue		$200,000

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 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 AASB 118 today to account for the two elements separately.

30 June 2018

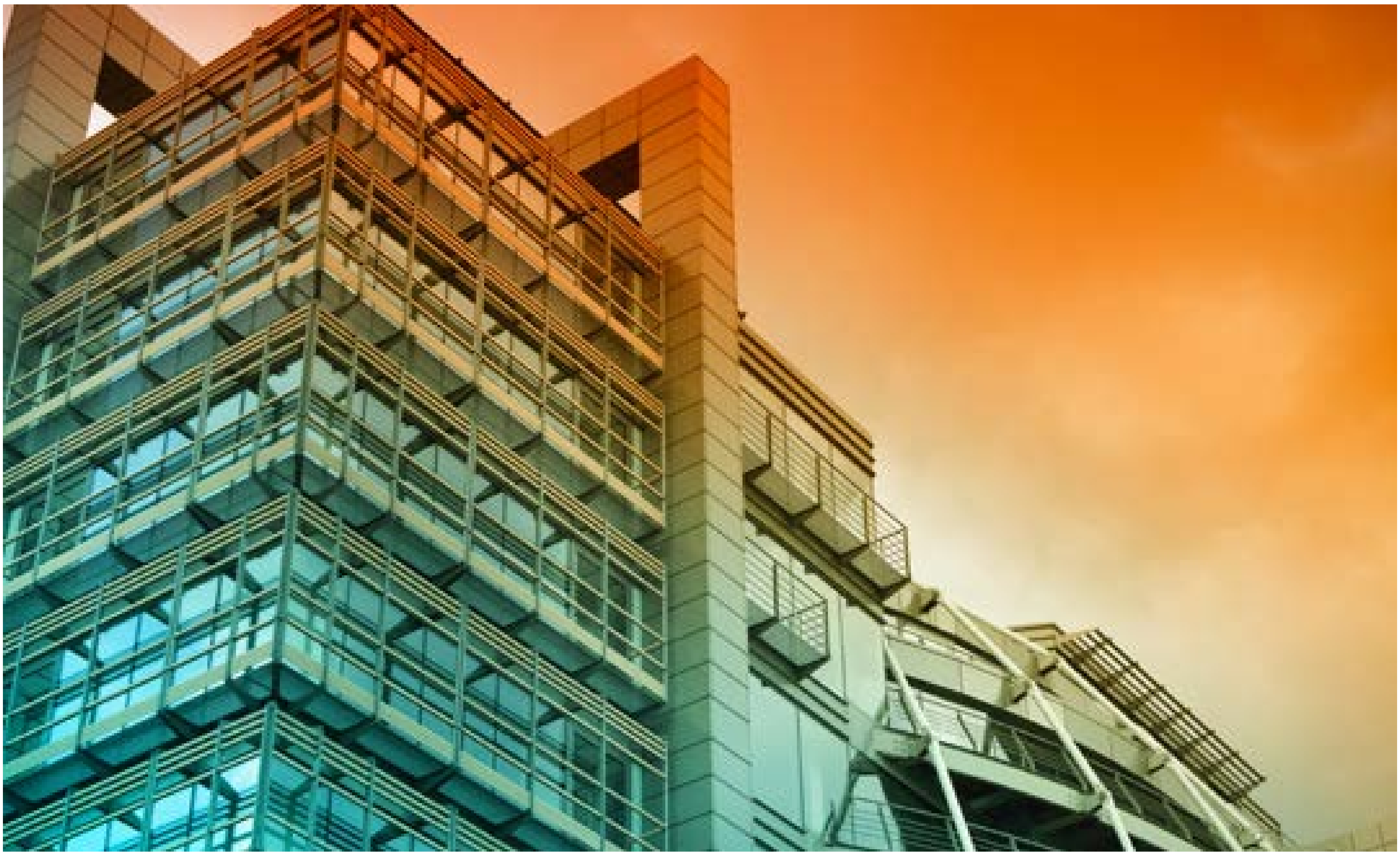
	AASB 118	IFRS 15
Revenue	$1,000,000	$750,000
Costs	$500,000	$500,000
Net profit	**$500,000**	**$250,000**

30 June 2019

	AASB 118	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 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.



APPENDIX A

The following two tables summarise the revenue and profit recognised for each of the reporting periods under AASB 118 Revenue and the new IFRS 15 standard.

AASB 118 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	$5,500,000	$5,500,000	$5,500,000	
Stage of completion	37.50%	62.50%	63.64%	81.82%	100.00%	
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**

IFRS 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 material 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%	40.00%	66.67%	100.00%	100.00%	
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	
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 JULY 2014, THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) FINALISED ITS PROJECT ON FINANCIAL INSTRUMENTS BY PUBLISHING IFRS 9 *FINANCIAL INSTRUMENTS* (2014) WHICH INCORPORATES THE FINAL REQUIREMENTS OF ALL THREE PHASES OF THE FINANCIAL INSTRUMENTS PROJECTS – CLASSIFICATION AND MEASUREMENT, IMPAIRMENT AND HEDGE ACCOUNTING.

The 2014 version of IFRS 9 adds the following to the existing 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.

The completed IFRS 9 (2014) applies to annual periods beginning on or after 1 January 2018, with relatively complex early adoption provisions.

In our August edition, 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 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 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).

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 are 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)

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	$950	
CR Financial asset		$950
DR Loss on sale (P&L)	$20	
CR OCI		$20

Other changes

In other changes, 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.

More information

Please contact Judith Leung for more information on IFRS 9 (2014).

NEW BDO PUBLICATIONS

The Audit section of our website includes a range of publications on IFRS issues. Look for the 'Global IFRS Resources' link which includes resources such as:

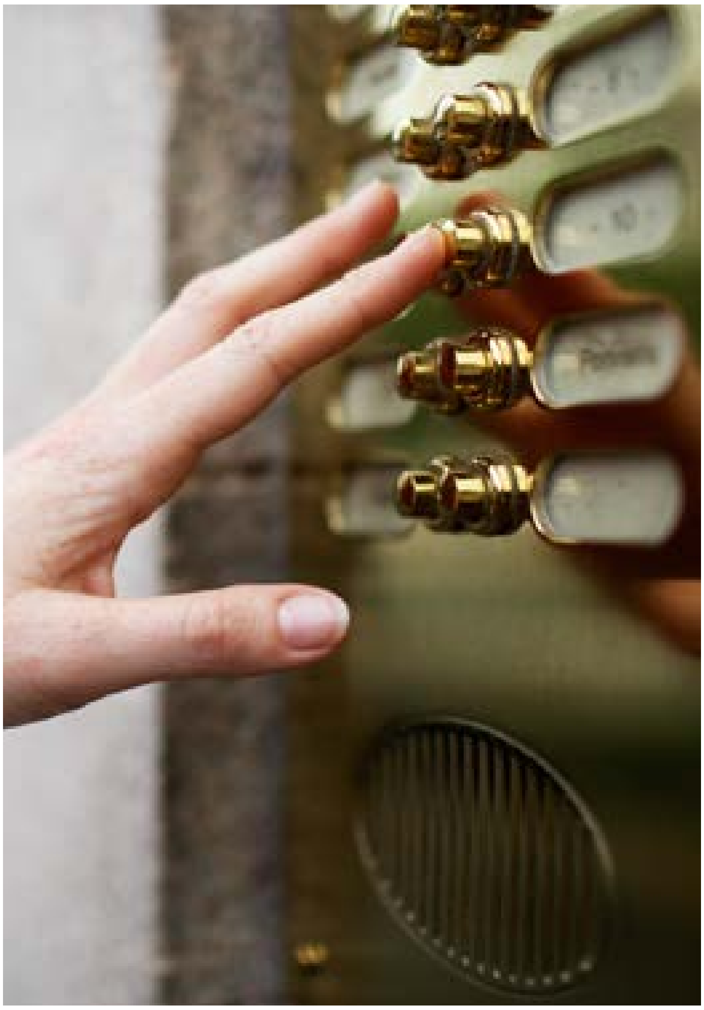
IFRS at a Glance – 'one page' and short summaries of all IFRS standards.

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 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* (May 2014), 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*.



COMMENTS SOUGHT ON EXPOSURE DRAFTS

At BDO, we provide comments locally to the Australian Accounting Standards Board (AASB) and internationally to the International Accounting Standards Board (IASB). We welcome any client comments on exposure drafts that are currently available for comment. If you would like to provide any comments please contact Wayne Basford at wayne.basford@bdo.com.au.

DOCUMENT	PROPOSALS	COMMENTS DUE TO AASB BY	COMMENTS DUE TO IASB BY
ED 253 *Recognition of Deferred Tax Assets for Unrealised Losses* Proposed amendments to AASB 112	Proposes to clarify the accounting for deferred tax assets related to debt instruments measured at fair value.	20 November 2014	18 December 2014
ED 255 *Financial Reporting Requirements for Australian Groups with a Foreign Parent*	Proposes amending AASB 128 *Investments in Associates and Joint Ventures* so that the ultimate Australian parent entity will need to apply the equity method in order to obtain the exemption for intermediate parent entity equity accounting at a lower level in the group.	24 November 2014	N/A
ED 256 *Removal of Cross-References from Financial Statements to Other Documents*	Various International Financial Reporting Standards include the ability to disclose certain information outside the financial statements, in documents attached to the published financial statements. Other than the audited remuneration report for companies that are disclosing entities, which has specific audit requirements, information disclosed outside the financial statements is generally not audited. In order to avoid any unintended audit consequences, the Australian Accounting Standards Board is proposing to remove options for disclosing certain information outside the financial statements, including: • AASB 1 *First-time Adoption of Australian Accounting Standards* – In the first interim financial statements, IFRS to previous GAAP reconciliations can be included by cross-reference to another published document • AASB 119 *Employee Benefits* – Information about defined benefit plans that share risks between entities under common control that can be included by cross-reference to disclosures in another group entity's financial statements.	28 November 2014	N/A
ED 254 *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value* Proposed amendments to AASB 10, AASB 12, AASB 127, AASB 128 and AASB 136	Proposes to clarify that the fair value of quoted investments and cash-generating units (CGUs) is the product of the quantity X quoted market price for the individual financial instruments that make up the investment or CGU.	12 December 2014	16 January 2015

FOR MORE INFORMATION

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