WEEK 5
Accounting for Leases
NZ IFRS 16

Why enter into a Lease?

- Finance an asset purchase (flexible, less costly, only option)
- To reduce the risk of obsolescence or technology factors
- Where an asset is only temporarily required

Summary: finance, prevent obsolete, short-term need

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Conceptual framework Definition

Asset

An asset is a resource controlled by the entity
as a result of past events
from which economic benefits are expected to flow to the entity
(NZ Framework, para 4.8)

Summary: resource controlled by entity, past transaction, increase entity resource

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Liability

A liability is a present obligation of the entity
arising from past events,
the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (NZ Framework, para. 4.15)

Summary: current obligation, past transaction, decrease entity resource

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The key accounting issue

Whether or not the leased assets and the associated commitments relating to the lease arrangement should appear in the reporting entity's statement of financial position.

-should lack of legal ownership preclude the lessee's reporting of the asset and the related liability in the statement of financial position?

Summary: Should we report asset and relating liability for lease?

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Main reason for change

While prior definition of an asset/liability may allow for it to be precluded (required ownership), current definitions of an asset/liability in the conceptual framework no longer justifies it - ultimately why leasing standards changed (aligns with conceptual framework and

thus provides more relevant and reliable information to stakeholders (e.g previously no knowledge of lease asset existence))

Summary: In past conceptual framework required ownership of assets so appropriate back then to omit. Current asset definition only requires control - no longer appropriate to omit.

Change in standard from IAS 17 to IFRS 16 was made to align with the conceptual framework and make information relevant and reliable for stakeholders (useful).

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Conceptual Basis

Asset definition, the issue is whether the resources are controlled, not whether they are legally owned

>Should recognise asset it does not own as long as

-able to control their use and (e.g when, where, how often used)

-past events and (e.g signed lease in past)

-through that control the economic benefits that flow from the resources (e.g used to help generate revenue)

Summary: leased object can be used in any way by the lessee as a result of the agreement transaction - it is expected to be used to generate income. Therefore assets.

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>Should recognise liability for asset it does not own as long as

-present obligation and (e.g lease payments)

-obligation of the entity arising from past events and (e.g signed lease in past)

-outflow from the entity of resources (e.g lease payments decrease profit)

Summary: the leased object creates an obligation for the entity through required payments as a result of the lease agreement - on payment it is expected to decrease the entity resource. Therefore it is a liability

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<u>Current Standard for lease (2019 onwards) [NZ IFRS 16]</u>

Accounting for leases is now governed by NZ IFRS 16

NZ IFRS 16 Lease Definition:

At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

>Leased assets are now called right-of-use

>All recognised as financial lease

Summary: Under IFRS 16 a lease is any contract that gives the entity control of a resource for a period of time in exchange for considerations - Use Finance lease reporting (reports assets and relating liability)

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Exemptions
Paragraph 5:
A lessee may elect not to apply the requirements in
paragraphs 22–49 to:
(a) short-term leases (less than 12 months); and
(b) leases for which the underlying asset is of low value (as described in paragraphs B3–B8).
>recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis
Summary: Can exclude reporting of lease if contract is less than a year or less than $1000 (whole asset - not component)

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<u>Previous Standard for lease (prior to 2019) [NZ IAS 17]</u>
NZ IAS 17 requirements differentiated between two types of leases:

- A finance lease
    - extent to which risks and rewards of ownership of a leased asset lie with the lessor or the lessee
- A operating lease
    - Anything that is not a financial lease

Summary: Under IAS 17 lease can be finance lease (reports assets and relating liability) or operating lease (reports only expense). Difference is determined by the extent of the risk and reward of ownership for lessee and lessor.

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<u>Reporting treatment</u>
Finance lease
Capitalised and recorded in the statement of financial position as:

- A leased asset (DR Leased Asset [IAS 17]) or (DR Right-of-use Leased Asset [NZ IFRS 16])
- A corresponding lease liability (CR Lease Liability)

>Essentially recognise as purchase asset using long term loan
>Recorded at lower of fair value of leased property or present value of minimum lease payment

- Prudence/Accounting conservatism: Take lower amount of value that makes business look good - Better to understate performance to prevent stakeholder being misled

Summary: in finance lease we recognised leased assets and relating liability by DR leased asset under IAS 17 or DR right-of-use leased asset under IFRS 16 and CR Leased Liability in statement of financial position which is recorded as the lower of fair value or present value of the minimum lease in accordance to accounting prudence concept (better to understate).

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Operating lease

Only recognise lease payment as expense in income statement

Summary: only recognise lease payments as expense in income statement

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Operating vs Finance lead to – Incentives to Misclassify Leases

Given that classifying a lease as an operating lease gave portrayed companies to operate at a better financial position (asset/liabilities recognition affected financial analytics, ratio and stakeholder perception) there was an incentive to misclassify/construct lease as operating lease

Negative impact of finance lease on financial position

- Increases non-current assets – reducing ROA ratios
- Increases non-current liabilities – adversely affecting debt/equity ratios
- Depreciation and interest charges may exceed lease payment in early years of lease – resulting in lower profits

>Business did not like change in standards as it negatively impacted perception of business financial health but accounting is to provide relevant and reliable information to stakeholders (useful) not to portray business in a good light

Summary: The finance lease was recorded on the statement of financial position, the operating lease was NOT. As a result there was an incentive to modify leases/misclassify to align with operating lease definition to present the entity in a better financial position (reporting of asset/liability negatively affected ROA, debt/equity, depreciation + interest exceeding lease payments resulting in lower profits).
More important to present useful information than present entity in good financial position.

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Terms

Fair Value

is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction

Summary: value of which independent party would pay for a resource

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Present Value

Calculation of future payment in today's dollar

Summary: today's dollar amount

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Interest rate implicit in the lease

Interest rate which causes total sum of all future payments to equal lease value

Summary: interest rate which causes total sum of all future payments to equal lease value

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<u>Calculation</u>

Summary:

1. ***Annuity rate = (Fair value - payment start of lease (beginning of period))/Annual payment***
2. ***Interest Rate = table 2 > year > closest annuity rate > interest rate***
3. ***First year:***
    - ***DR Right-to-use leased asset = fair value***
      CR Leased liability = fair value
    - ***DR Leased Liability = payment start of lease***
      CR Cash = payment start of lease

   Year two onwards:
    - ***DR Depreciation expense = (fair value/year or life)***
      CR Right-to-use leased asset = (fair value/year or life)
    - ***DR Interest expense = interest rate * last year leased asset balance***
      DR leased liability = year payment - Interest expense
      CR cash = year payment

Simple Class Example

- A machine is leased for 3 years with annual payments of $10,000.
- The Fair Value of the machine at inception of the lease is $24,869.
- The economic life of the machine is 3 years and the lease is non-cancellable.

Step 1:
Calculate discount rate
Future annuity payment * annuity factor = PV of annuity payment

What discount rate will equate the annuity of payments of $10,000 with the fair value of $24,869?
10000 * annuity factor = 24869
annuity factor = 24869/10000
annuity factor = 2.4869
Implicit rate = Go to table B -> 3 years -> closest annuity factor -> 10%

Step 2:
Allocating the lease payments in the form of a lease payments schedule

Date	Lease Payment	Interest Expense (10%)	Principal Reduction	Outstanding Balance
30 June 20XX (Start of lease)				24,869
30 June 20XX (end of Year 1)	10,000	2,487	7,513	17,356
30 June 20XX (end of year 2)	10,000	1,736	8,264	9,091
30 June 20XX) (end of year 3)	10,000	909	9,091	0

>Interest expense = Lease payment * annuity factor = 10000*0.24869 = 2487
>Principal reduction = Lease payment - Interest expense = 10000 - 2487 = 7513
>Outstanding Balance = Prev Outstanding Balance - Principal reduction = 24869 - 7513 = 17356

Step 3:
Prepare Journals
>Depreciation is divided over lifetime if asset becomes lesse at end of lease, otherwise divide over term of lease

Journal entries (for the Lessee)

Start of lease	DR Leased Assets	24869
	CR Lease Liability	24869
	To record the leased asset and lease liability (at PV of minimum lease payments)	
End of year 1	Dr Lease depreciation expense	8290
	Cr Accumulated depreciation	8290
	To record depreciation expense (24,869/3= 8,290)	
End of year 1	Dr Lease liability	7513
	Dr Interest expense	2487
	Cr Cash	10000
	To record the lease payment, with the payment being allocated between principal and interest	
End of year 2	Dr Lease depreciation expense	8290
	Cr Accumulated depreciation	8290
	To record depreciation expense (24,869/3= 8,290)	
End of year 2	Dr Lease liability	8264
	Dr Interest expense	1736
	Cr Cash	10000
	To record the lease payment, with the payment being allocated between principal and interest	
End of year 3	Dr Lease depreciation expense	8290
	Cr Accumulated depreciation	8290
	To record depreciation expense (24,869/3= 8,290)	
End of year 3	Dr Lease liability	9091
	Dr Interest expense	909
	Cr Cash	10000
	To record the lease payment, with the payment being allocated between principal and interest	

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Example 1

1. On 1 July 2011, Flyer Limited decided to lease an aeroplane from Finance Limited. The term of the lease was twenty years. The aeroplane is expected to be scrapped at the end of the lease term. The fair value of the aeroplane at the commencement of the lease, is $2 428 400. The lease requires a lease payment of $300 000 on the inception of the lease (on 1 July 2011) and lease payments of $250 000 on 30 June each year (starting 30 June 2012). There is no residual payment required.

   Required:

   (a) Calculate the interest rate implicit in the lease.
   (b) Provide the journal entries for the lease in the books of Flyer Limited as at 1 July 2011.
   (c) Provide the journal entries for the lease in the books of Finance Limited at 1 July 2011.
   (d) Provide the journal entries in the books of Flyer Limited for the final year of the lease (i.e. the entries in 20 years' time).
   (e) Provide the journal entries in the books of Finance Limited for the final year of the lease (i.e. the entries in 20 years' time).

a)
2428400 - 300000 = 2128400
250 000 * annuity factor = 2128400
annuity factor = 2128400/250 000
annuity factor=8.5136
Implicit rate =Go to table B -> 20 years -> closest annuity factor -> 10%

PV = 300000 + (250000*8.5136) = 2428400

b)
Journal entries (for the Lessee)

Start of lease	DR Leased Assets	2428400
	CR Lease Liability	2428400
	To record the leased asset and lease liability capitalisation (at PV of minimum lease payments)	
	Dr Lease Liability	**300000**
	Cr Cash	**300000**
	Recognise first payment on lease inception	

d)

Date	Lease payment for aircraft	Interest expense	Principal reduction	Outstanding balance
1-Jul-11				2,128,400
30-Jun-12	250,000	212,840	37,160	2,091,240
30-Jun-13	250,000	209,124	40,876	2,050,364
30-Jun-14	250,000	205,036	44,964	2,005,400
30-Jun-15	250,000	200,540	49,460	1,955,940
30-Jun-16	250,000	195,594	54,406	1,901,534
30-Jun-17	250,000	190,153	59,847	1,841,688
30-Jun-18	250,000	184,169	65,831	1,775,857
30-Jun-19	250,000	177,586	72,414	1,703,442
30-Jun-20	250,000	170,344	79,656	1,623,787
30-Jun-21	250,000	162,379	87,621	1,536,165
30-Jun-22	250,000	153,617	96,383	1,439,782
30-Jun-23	250,000	143,978	106,022	1,333,760
30-Jun-24	250,000	133,376	116,624	1,217,136
30-Jun-25	250,000	121,714	128,286	1,088,850
30-Jun-26	250,000	108,885	141,115	947,735
30-Jun-27	250,000	94,773	155,227	792,508
30-Jun-28	250,000	79,251	170,749	621,759
30-Jun-29	250,000	62,176	187,824	433,935
30-Jun-30	250,000	43,393	206,607	227,328
30-Jun-31	250,000	22,733	227,267	61

Note:
The small difference at the end of year 20 is due to rounding up of the rate to 10%. This would likely be adjusted in the last period as has been done in the entries above. That is, the principal reduction in the last period needs to be $227,328 meaning the interest expense for the last period will be $22,672 [22,733 less 61].

Journal entries (for the Lessee)

End of year 20	Dr Lease depreciation expense	121420
	Cr Accumulated depreciation	121420
	To record depreciation expense (2428400/20= 121420)	
End of year 20	Dr Lease liability	223328
	Dr Interest expense	22672
	Cr Cash	250000
	To record the lease payment, with the payment being allocated between principal and interest	

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WEEK 10
Related Party Disclosures
NZ IAS 24

Objective: What is the rationale for related party disclosure [IAS 24]
To ensure that and entity's financial statement draws attention to the possibility that its financial position and profit or loss (operation) may have been affected by the existence of related parties - even if transactions do not occur (e.g subsidiary terminate relations with trading partner or stop activities (e.g R&D) on order of parent)
and by transactions and outstanding balances including commitments with such related parties (e.g increased risk due to fraud, remuneration manipulation, tax avoidance, transaction misstated, transaction with parent at lower cost than FV).
This is because this information may be important to users as it affects their decision and judgement relating to the reporting entity risks and opportunities (material).

Summary: the rationale for related party disclosure is that profit or loss may have been affected by

1. **the existence of related parties**
2. **transactions and outstanding balances including commitments with such related parties**

This is material to users' decisions and judgement of reporting entity risk and opportunities.

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Scope: What disclosure [IAS 24]
Relationships between related parties must be disclosed irrespective of whether there have been transactions between them - existence is enough.

Summary: regardless of if transactions occur between related parties tier 1 & 2 must disclose.

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The components are:
-Nature of the relationship
-Transaction undertaken (amount)
-Outstanding balance (including commitments- conditions guarantees)
-Doubtful debts related to outstanding balance and expense related to doubtful and bad debts
-Remuneration for Key personnel provided by SE (amount)

Summary: disclosure must include nature of relationship, transactions (amount), outstanding balance and commitments, doubtful debts resulting from outstanding balance and related expense of doubtful and bad debts

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Examples of related party transactions that must be disclosed include:
A related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party transactions regardless if a price is charged (doesn't require monetary exchange)

- Purchases or sales of goods or services
- Acquisition or disposal of assets
- Leases
- Transfers
- Provision of guarantees or collateral
- remuneration arrangements for key management personnel (in total - commercial sensitivity)

Summary: transactions that must be disclosed are leases, sale/purchase of asset, sale of service/goods, transfers, provision of guarantee/collateral and remunerations

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If the relationship is between a parent and subsidiary IAS 24 is required in addition to:
-IFRS 12 Disclosure of interest in other entities
-IAS 27 Separate Financial Statements

Summary: If related party is a subsidiary must also report IFRS 12 and IAS 27

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What is a related Party
A related party is a person or entity that is related to the entity preparing its financial statements - someone/entity that has power to influence/control corporate activity or are under common control which means they can impact profit/loss (material).

This includes:

- Where a person or entity is a member of the key management or personnel of the entity or its parents
- Close family members of the related party (e.g spouse, child (in laws, adopted), dependents)
- Entity/Person who has control (majority shareholder), joint control (partnership between two company) or significant influence (at least 20%)
- Member of group (is parent, child or subsidiary)
- Situation where both entities are under common control of another party

Summary: someone related to an entity preparing financial statements that can influence the performance of the reporting entity such as directors, close family,

subsidiary, control, joint control, associate, another company that shares common influence etc.

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Identifying related parties: Person
Person or close family of person who:

-has control (majority shareholder: 50%+), joint control or significant influence (Associate: 20%-50%)

-is a member of the key management personnel

- Have the authority and responsibility to plan, direct and control the activities of organisations directly or indirectly.
  >PBE: no clear director structure - use substance over form

-key management personnel of the entity's parents

>for PBE: includes those who provide oversight functions and key advisors

Summary: A person is a related party if they have or their close family member has control, joint control or significant influence over the reporting entity or they are a key personnel of the reporting entity or its parent

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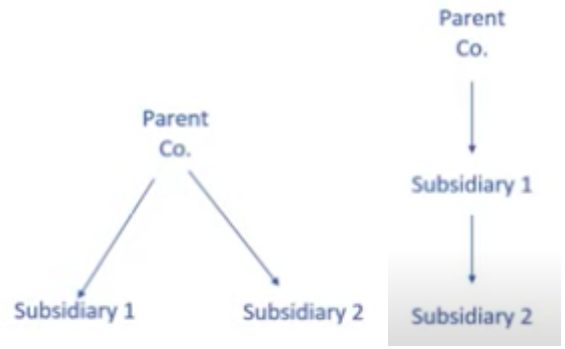
Identifying related parties: Entity
Reporting Entity: RE
Second Party Entity: SP
Third Party Entity: TP

1. The entity and the reporting entity are members of the same group.
2. One entity is an associate or joint venture of the other entity
3. Both entities are joint ventures of the same third party.
4. One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
5. The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
6. The entity is controlled or jointly controlled by a related person of the reporting entity.
7. A person having control or joint control of the reporting entity (or his close family member) has significant influence over the entity in question or is a member of the key management personnel of this entity (or of a parent of this entity).
8. The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

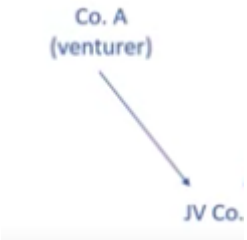
General

1. RE and SP is part of the same group (Parent and subsidiary and subsidiary's subsidiary)
   >B is subsidiary of A and C is subsidiary of B = A and B and C related

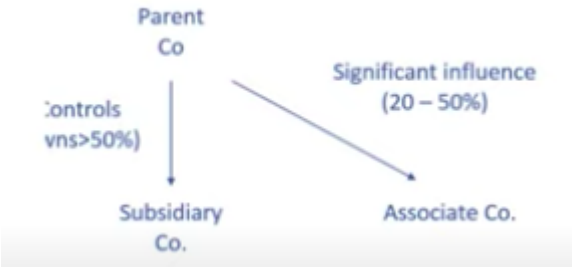
>B is subsidiary of A and C is subsidiary of A = A and B and C related
-must disclose parent and ultimate parent



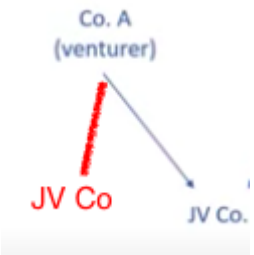
2. One entity is an associate or joint venture of the other entity
>A is associate or joint venture of B = A and B related
>B is associate or joint venture of A = A and B related



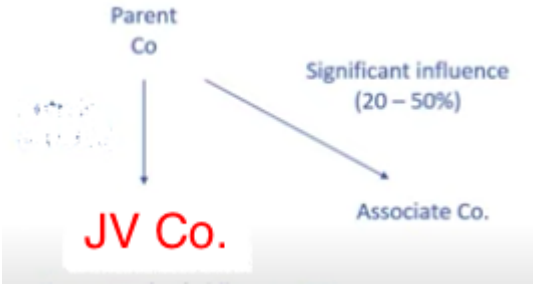
3. One entity is an associate or joint venture of the other entity group
>B is associate or joint venture of A, A is parent of C = A and B and C related



4. RE and SE are joint ventures of TP
> A and B is joint venture of C = A and B and C related



5. One entity is a joint venture of a third party and the other entity is an associate of the third entity
>A is joint venture of C and B is associate of C =A and B and C related

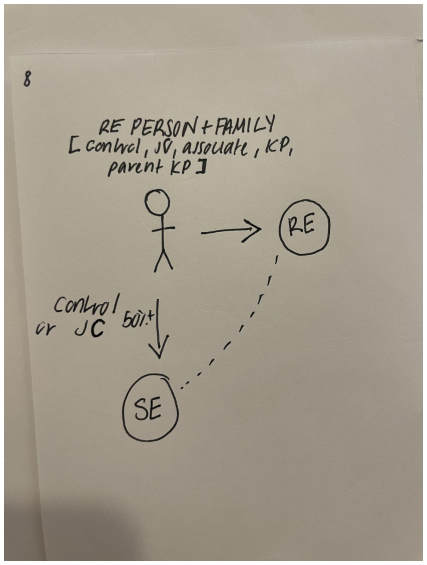


Employment benefit

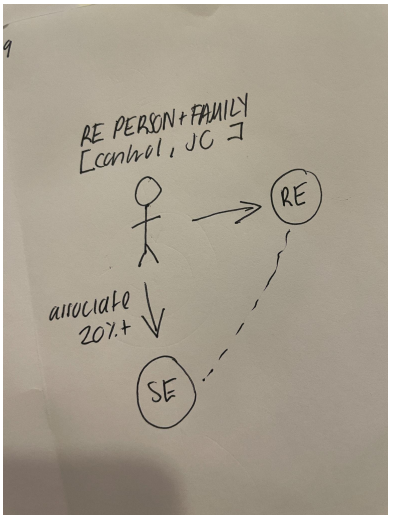
6. The SE is a post-employment defined benefit plan for the benefit of employees of either the RE or an entity related to the RE.
7. If RE is a post-employment benefit plan, the sponsoring employers are related to the reporting entity.

Related Person

8. The SE is controlled or jointly controlled by a related person (or family) to the RE.
   >K or family joint/controls B and is a related person of A = A and B related

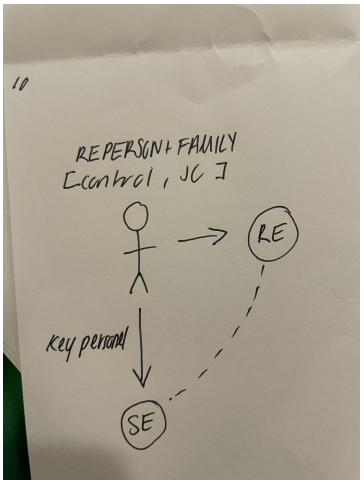


9. A related person (or close family) through control or joint control of RE has significant influence over the SE
   >K or family joint/controls A and is an associate of B = A and B related



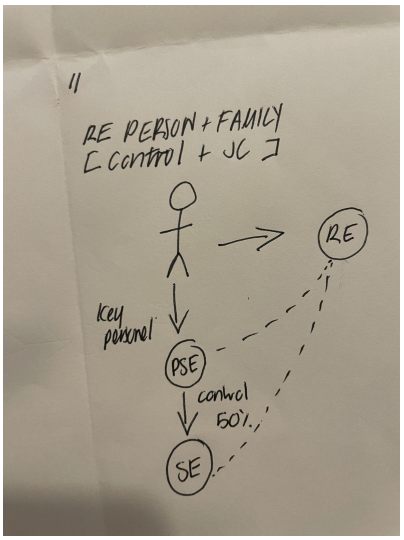
10. A related person through control or joint control of RE is a member of the key management personnel of the SE

    >K or family joint/controls A and is a key personnel of B = A and B are related



11. A related person through control or joint control of RE is a member of the key management personnel of the SE's parent entity

    >K or family joint/controls A and is a key personnel of B's parent = A and B are related



12. The SE, or any member of a group of which it is a part, provides key management personnel services to the RE or its parent entity

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Relationship that are not related

1. Commonality:
   - -2 entities with Key personnel in common
   - -2 entities where Key personnel of A has significant influence over B
   - -2 Joint venturers who share control of a joint venture
   - -2 Associates with parent in common
2. Following entities who have normal dealings:
   - -Provider of finance
   - -Trade union
   - -Public utilities
   - -Departments and agencies of a government that does not control, jointly control or have significant influence
3. Following entities who have dependencies or transact with:
   - -Customers
   - -Suppliers
   - -Franchisor
   - -Distributor or general Agent

Summary:
Common:
Not related where two company have key personnel in common, where one of the two company key personnel have significant influence over the other, where two joint venturer have control of the same entity

Normal dealings:
Financial institutions, Trade union, Government, Public utilities

Dependencies or transact:
Customer, Supplier, Franchisor, Distributor

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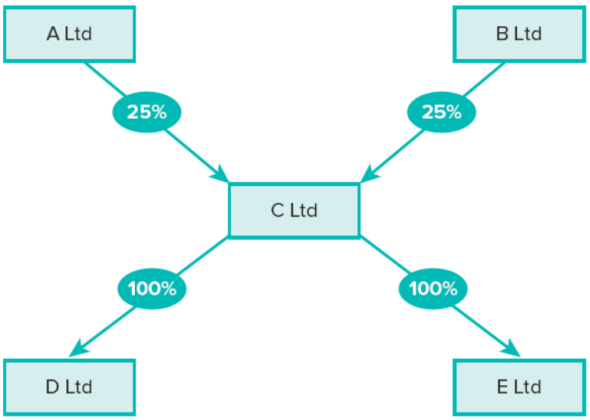
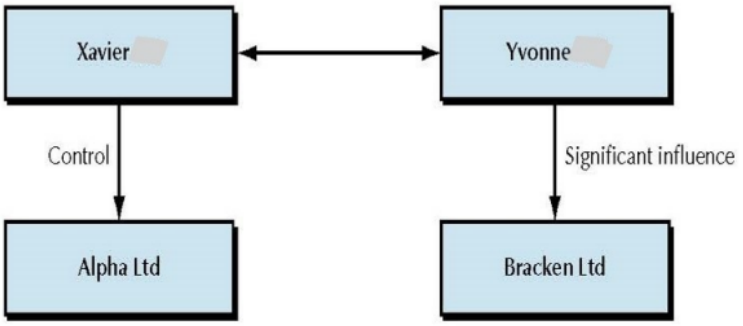
<u>Examples</u>
Example 1



-A & B not related - no significant influence or control
-A & B are related parties of C as they have significant influence over C
>One entity is an associate, subsidiary or joint venture of the other entity
-D & E are related parties of C because they are C's subsidiary (common control)
>One entity is an associate, subsidiary or joint venture of the other entity
-D & E are related parties because they are both C's subsidiary (common control)
>RE and SE are joint ventures/subsidiary of TP

Example 2

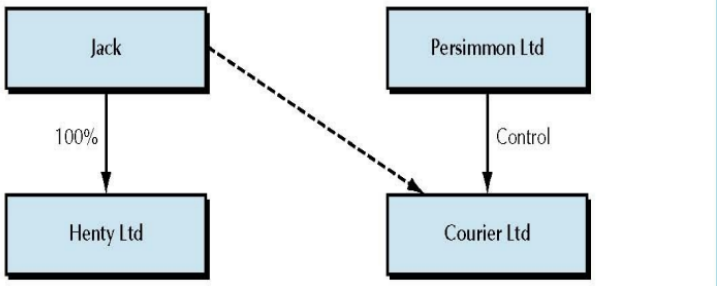
Xavier is married to Yvonne and he has a controlling investment in Alpha Ltd. Yvonne holds an investment in Bracken Ltd that gives her significant influence over that company.



-B related party of A because Xavier controls A and his close family member Yvonne has significant influence over B
>The SE is controlled or jointly controlled by a related person (or family) to the RE.
-A is related party to B as Yvonne has significant influence over B and her close family member Xavier controls A
>A related person through control or joint control of RE has significant influence over the SE
>if Xavier only has significant influence A & B would not be related

Example 3

Jack has a 100% interest in Henty Ltd and he is also a member of the key management personnel of Courier Ltd. Persimmon Ltd has a controlling interest in Courier Ltd.



-H is related party of C as Jack has control of H and is a key personnel of C
>The SE is controlled or jointly controlled by a related person (or family) to the RE.
-C is a related party of H as jack is a key personnel of C and has control of H
>A related person through control or joint control of RE is a member of the key management personnel of the SE

Example 4

• A person who has the authority to plan, direct and control the activities of the entity
>Related
• The domestic partner and children of a director of the entity
>Related
• The non-dependent sister of a director of the entity
>Not related
• A subsidiary company that is directly controlled by the entity
>Related
• A trade union that the majority of the entity's employees belong to
>Not related
• A supplier that is economically dependent on the entity
>Not related

Example 5

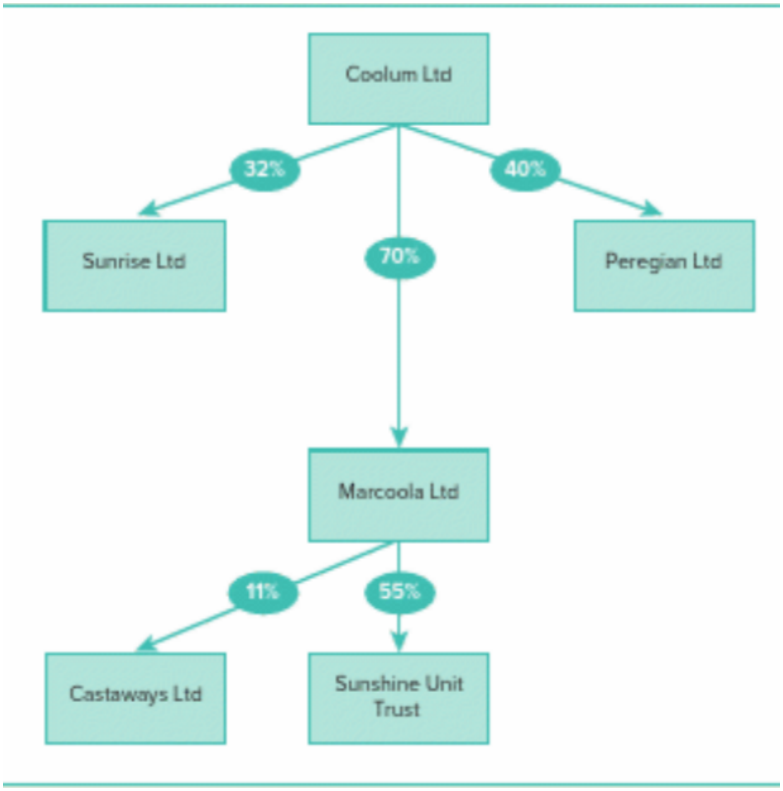
Assume that Figure 23.3 represents the structure of some entities in an Australian group. The percentage ownership is shown, and these percentages are deemed to be representative of voting rights.

The directors of the entities are as follows:

Coolum Ltd	Smith, Jones
Sunrise Ltd	Green, Black
Peregian Ltd	White, Sand
Marcoola Ltd	Long, Board
Castaways Ltd	Short, Wax
Sunshine Unit Trust	Reddy, Brown

REQUIRED

(a) Identify the related parties of Marcoola Ltd.
(b) Identify the entities that are not related to Marcoola Ltd.
(c) Identify the related parties of Peregian Ltd.
(d) Identify the entities that are not related to Peregian Ltd.



A) Maracoola related parties:
Coolum - Yes, has control of RE (parent)
Sunshine - Yes, Re has control (subsidiary)
Smith, Jones - Yes, Key personnel of parent
Long, Board - Yes, Key personnel of RE

B) Maracoola unrelated parties:
Sunrise + key personnel - No, parent is only associate unless evidence of shares being dispersed
Peregian + key personnel - No, parent is only associate unless evidence of shares being dispersed
Castaways + key personnel - No, does not meet minimum of significant influence

C) Perigan related parties:
Coolum - Yes, has significant influence of RE, may be parent if evidence of share being dispersed
White, Sand - Yes, Key personnel of RE

D) Perigan unrelated Parties:
Sunshine + key personnel - No, Coolum may indirectly control but Coolum not parent or child of Perigan
Sunrise + key personnel - No, associate of coolum but common associate not related
Maricoola + key personnel - No, Coolum may control but Coolum not parent or child of Perigan
Cataways + key personnel - No, Not related to any company

WEEK 10

Segment Reporting
IFRS 8 - ONLY FOR PROFIT

What is segment reporting
Segment reporting provides information about the performance of sub units of an organisation.
Segment disclosures are reported on the basis of whatever accounting methods the entity utilises to generate information for the 'chief operating decision maker'.

This is only applicable to the group or individual statement for entities who have issued or are in the process of issuing debt or equity securities into a public market (shares).
>Only for profit, not applicable to PBE

Summary: For profit entities who issue share must disclose the performance of their subunits

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Rational for segment reporting
The consolidated financial statements are an aggregation of all the segments of a companies as a result this may conceal the unsatisfactory performance of certain subunits which has the potential to impact the future performance of the entity (profit/loss) - this means that the knowledge of the performance of each subunit may affect the decision or judgement of a user thus it must be disclosed as per materiality.

Other considerations:
Benefits:
>managers may want to disclose as it increase accountability and likelihood of greater investment funding - some report beyond amount required by standards
>enables users to better predict future profitability of the company as it provides more relevant and reliable information
>highlights performance of various business segment
>May promote investment from investors who support specific segment activities

Cost:
- Costs on reporting entity
    - Direct cost: cost of information processing and dissemination
    - Indirect cost: competitive advantage (profitable segments targeted by competitors)
    - Shareholder/regulatory pressure to liquidate unprofitable segments
    - May deter investment from investors who do not support specific segment activities
- Cost to managers
    - May reveal managers' shortcomings (less willing to take risk)
    - Risk of takeover bids

Summary: the purpose of segment reporting is to reveal the performance of the individual units within a company this is to ensure that the operations of these units are represented fairly and under performance is not concealed by the consolidated

statements which could impact the entities future profit/loss. This information may affect the user's judgement and decision and therefore must be disclosed (material). The benefits of this is higher accountability resulting in higher likelihood of investment, more relevant and reliable information for users to make future predictions and highlights strengths of the companies business segments.

The cost of this for reporting entities is the direct cost of generating and presenting this information and the indirect cost of competitive advantage due to decrease obscurity of commercial sensitivity there are also cost for managers in the form of increase risk of takeover bid and higher performance scrutiny

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IAS 14 to IFRS 8

Under IAS 14, segment reporting was determined by the good/service provided to customer and or geographic location.

Now under IFRS 8 we have adopted the management approach:
-segment information based on what is reported internally to Chief operating decision maker (CODM)
-segments are identified by same measurements used for internal review
-line item disclosures are measured in the same way as internal review
>benefits
-fewer cost since using same info provided to CODM internally
-review operation through eyes of management

Summary: Prior to IFRS 8 we has IFRS 14 - under IFRS 14 we disclosed segment based on good/service provided to customer and or geographical location however under IFRS 8 we use the management approach. The management approach identifies segment by only considering segments that are presented to CODM for internal review.

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Controversy:
Mistrust of management intention from investor (completing objectives, portrayal of entity operation may not reflect reality)
>obscurity of management structure due to concerns of commercial sensitivity - loss of competitive advantage
>mask loss making activities - only consider what is presented to CODM hence they can dictate what is a segment
>Less reliable as accounting is any form preferred internally - may not align to standards

Summary: There is controversy associated with IFRS 8 as disclosure is dependent on internal reporting this gives rise to concerns around obscuring of weak segments to

mask loss making activities as well as cost outweighing benefits (reputation, commercial sensitivity, cost to produce)

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Requirements of IFRS 8: core principles

• Requires an entity to report financial and descriptive information about its reportable (operating) segments
• Requires reconciliation of total reportable segment information to corresponding amounts reported in the financial statements (Measurement for segments might be different to financial statements - help users understand where figures come from)
• Requires reporting of additional information about the entity's products and services, the geographical areas in which it operates and its major customers (few majority customers or cultural/political/environmental nature of geography presents risk)

Summary: IFRS 8 requires reporting of segment (financial and descriptive), reconciliation of total reportable segment to correspond with financial statements, additional reporting on entity's products and services, the geographical areas and major customer

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Step 1: Identifying Operating Segment

1, Identify chief operating decision maker (CODM) [function not role title]
2. Identify segment

Must have all 3 characteristics:

1. Generate revenue (internally or externally) and incur expense from business activities - must earn revenue, cannot just incur expense (e.g IT headquarter)
2. Operating results are regularly reviewed by the entity's chief operating decision maker as a basis for resource allocation and performance assessment
3. Discrete information is available

Summary:
1.identify CODM
2. Identify segments that generate both revenue and expense, is reported to CODM and has discrete values

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Step 2: Identifying reportable operating segment

Must have all 2 characteristic:

1. Identified as operating segment (or aggregated with other segment where permitted) [step 1]
2. Exceeds quantitative threshold

Summary: passed step 1 and aggregated if required as well as meeting one of three thresholds

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Aggregate segment
Segments are aggregated if they have similar economic characteristics (e.g long term gross margin) and have similar:
• Nature of products and services
• Nature of production processes
• Type or class of customer
• Methods of distribution
• Nature of regulatory environment (if applicable) (para 12)
>controversial: requires judgement and can hide loss

Summary: Segments that have similar economic characteristics as well as product/service, customers, production process, distribution, regulation - aggregation is controversial as it is subjective and has the potential to conceal weak segments

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Quantitative threshold
Must have any 1 of 3:

- Revenue is 10% of combined revenue of all operating segments
- Absolute amount of profit or loss is 10% or more of the greater of:
    - combined profits of profit making segments and
    - combined losses of all loss making segments;
- Assets are 10% or more of combined assets of all operating segments

Summary: either at least 10% of combined revenue, absolute value is 10% of greater of total profit or loss segments, or 10% of combined assets

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Step 3: Consolidated revenue check
If total external revenue from reportable segments is less than 75% of total revenue, we must identify other segments (even if they do not qualify as a reportable segment) until at least 75% of revenue is reported
>Max segment 10
>All other segment combined under ‘all other segment’ category

When company size grows or shrinks any segment that was once considered a reporting segment continues to be reported even if it no longer qualifies or if a new segment qualifies we must report its performance in the previous period (unless cost is too great or info not available).

Summary: all reported segments must be at least 75% of all external revenue - if not need to report other segment even if they do not meet segmentation requirements

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Step 4: Disclosure

1. General statement on factors used to identify reportable segment and type of product/service each segment provides
2. profit /loss for each segment
3. Explanation of the measurements of segment profit or loss, segment assets and segment liabilities including the:
    - Basis of accounting for segments;
    - Difference of measurements between segment and entity
    - Changes from prior periods etc
4. Information about assets and liabilities and specific revenues and expenses where they are regularly provided to the chief operating decision maker
5. Reconciliations of key items between the total of the reportable segments and the entity totals e.g. revenues, profit or loss etc
6. Information about products or services, geographical areas and major customers (applies even to entities with only one reportable segment)

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Summary:
Need to disclose for each segment

1. **How segment identified + good/service**
2. **profit/loss**

As well as

1. **asset/liability/revenue/expenses provided to CODM**
2. **Measurement of profit/loss/asset/liabilities including basis of accounting between segments, difference between segment and entity measurements and changes from prior period**
3. **Reconciliations of key items between the total of the reportable segments and the entity totals e.g. revenues, profit or loss etc**
4. **Information about products or services, geographical areas and major customers**

Example

Example 1

• Company A has a CEO, a COO and an executive committee comprising the CEO, COO and the heads (general managers) of three business units – units X, Y and Z.
• Every month, financial information is presented to the executive committee for each of business units X, Y and Z and for Company A as a whole so as to assess the performance of each unit and of the company as a whole.

• Units X, Y and Z each generate revenue and incur expenses from their business activities. Unit Y derives most of its revenue from Unit Z.
• Corporate headquarter costs that are not allocated to units X, Y and Z are also reported separately each month to the executive committee to determine the results for Company A as a whole.

Step1: Identify segment
CODM: executive committee (not explicitly stated - likely as they perform reviews on operating results)

X- generates profit/expense, reviewed by CODM, discrete
Y- generates profit/expense, reviewed by CODM, discrete
X- generates profit/expense, reviewed by CODM, discrete
Corporate headquarter: no - reviewed by CODM and discrete however only generates expense

Step2: Identify reportable segment

	Unit X	Unit Y	Unit Z	Total Operating segment	Head quarters	Other business	Total Company
Revenue	200	100	400	700	-	230	850
Profit/Loss	50	30	100	180	(25)	20	165
Assets	800	300	950	2050	250	200	2500

>Y internal rev = 80

	X	Y	Z	Outcome
Revenue	200/700=29%	100/700=14%	400/700=57%	All greater than 10%
Profit/loss	50/180=28%	30/180=17%	100/180=55%	All greater than 10%
Asset	800/2050=39%	300/2050=15%	950/2050=46%	All greater than 10%

>All X, Y, Z meet at least 1 requirement of minimum threshold and therefore must be reported

Step3:
total revenue (700-80)/850 < 75% therefore other segments required

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Example 2

Turner Limited is a listed retail company, with all its stores located in New Zealand. It has three main types of stores: toy stores, fashion stores and book stores. Each of these stores has different products, customer types and distribution processes. Based on information supplied to the chief operating decision maker, Turner Limited has *initially* identified three operating segments: toy stores, fashion stores and book stores.

The following table shows Turner Limited's financial information relating to each of these three operating segments and the total consolidated information for the year ended 31 March 2023.

	Toy stores $ (000)	Fashion stores $ (000)	Book stores $ (000)		Total (consolidated) $ (000)
Revenue	2,800	700	400		5,400
Profit/(loss)	250	160	(45)		470
Assets	5,200	1,300	700		8,700

All three of these operating segments earn their revenues almost exclusively from external customers. However included in the toy stores' revenue is $30,000 of revenue earned from book stores.

Required:

(a) State whether each of the following statements (i)-(v) are true or false. Give reasons for your answers along with reference(s) from NZ IFRS 8.

i. The revenue figure that should be used by the toy stores segment for the purposes of determining whether or not it is a reportable segment is $2,770,000.

False - all revenue is considered regardless of if it was acquired through internal sales thus value is $2,800,000 (NZ IFRS 8, para 13(a))

ii. Based on the initial identification of the three operating segments, the profit (loss) figure that should be used by Turner Limited for the purposes of determining reportable segments is $365,000.

False - should be greater of sum of profit segments or sum of loss segment thus it should be $410,000 (NZ IFRS 8, para 13(b))

iii. The $30,000 revenue the toy stores segment earned from book stores should be excluded when applying the 75% threshold test in NZ IFRS 8.

True - the segments must make up 75% of external revenue which is $5,370,000 NZ IFRS 8 (NZ IFRS 8, para 15).

iv. Turner Limited has three reportable segments.

False - toy store (2800>540) and fashion (700>540) each make up more than 10% of revenue, and book store makes up more than 10% of profit/loss (45>41) however they do not meet the 75% threshold for external revenue and will need to add segments 3870000/53700000. (NZ IFRS 8, para 15).

v. Turner Limited is not required to provide a reconciliation between information reported for reportable segments and the related information for the entity as a whole as it would be too costly to prepare.

False.

As per management approach in IFRS 8 Segment disclosures are reported on the basis of whatever accounting methods the entity utilises to generate information for the ‘chief operating decision maker’.

Users might have trouble understanding how segment information relates to that provided elsewhere in the financial reports as the basis of internal and external reporting may be different.

Accordingly, NZ IFRS 8 (para 28) requires reconciliations of total reportable segment revenues, total profit or loss, total assets, total liabilities and other amounts disclosed for reportable segments to the corresponding amounts shown in the entity’s financial statements. (NZ IFRS 8, para 28).

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WEEK 11
Accounting for Financial Instruments
NZ IAS 32

Past VS Present
• Prior to 2005 the only applicable standard was IFRS-31 'Disclosure of Information about Financial Instruments'

• Current:
NZ IAS 32 'Financial Instruments: Presentation'
NZ IFRS 7 'Financial Instruments: Disclosures' (November 2005)
NZ IFRS 9 'Financial Instruments' (issued September 2014)
>IFRS 9 REPLACES NZ IAS 39 - IAS 39 was hard to measure for preparers and understand for user, loan loss recognised when it occurred (when borrows defaulted - this is too late) but now loan loss recognised when significant increase in credit risk (expected cost model)

Summary: previously IFRS 31 was used to recognise financial instrument, now it is IAS32, IFRS 7, IFRS 9
Pre IFRS 9 we has IAS 39 - this was replaced because it was hard for users to understand and preparers to report (loss now recognised when significant risk increase)

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What are Financial instrument [IAS 32]
any contract that gives rise to both
-a financial asset to the holder of the instrument (buyer) and
-a financial liability or equity instrument to the issuer of the instrument (seller)

TABLE 7.1 Summary of common financial instruments

Financial assets	Financial liabilities	Equity instruments
Cash	Bank overdraft	Ordinary shares
Accounts receivable	Accounts payable	Certain preference shares
Notes receivable	Notes payable	
Loans receivable	Loans payable	
Derivatives with potentially favourable exchange conditions	Derivatives with potentially unfavourable exchange conditions	
	Certain preference shares	

Summary: a contract that gives rise to a financial asset to the holder of the financial instrument and a financial liability or equity instrument to the issuer of the financial instrument

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Example

Example 1

On 1 July 2023 Buyer Ltd purchases an option contract from Seller Ltd for $1000 that gives Buyer Ltd the right (or 'option') to acquire 10000 shares in Bells Ltd (a third organisation) for a price (exercise price) of $5.00 per share. When the contract was exchanged the price of Bells Ltd's shares was $4.50 each. The option entitles Buyer Ltd to exercise the options to buy the shares at any time within the next six months. If the options are not exercised within the six-month period, they will expire on 31 December 2023.

REQUIRED Determine whether a financial liability or financial asset exists

options contract establishes a financial instrument that

(Financial Asset) gives Buyer Ltd the right to acquire 10000 shares in Bells Ltd for $5.00 a share and

(Financial Liability)creates an obligation for Seller Ltd to sell 10000 shares in Bells Ltd to Buyer Ltd for $5.00 a share.

> Asset because exchange is potentially favourable for buyer (doesn't have to be certain or probable)

> Liability because exchange is potentially unfavourable for seller (doesn't have to certain for probable)

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Example 2

(a) Company A loans Company B $400000 repayable in two years.

>A financial asset - right to receive cash from B

>B financial liability - obligation to pay cash to A

(b) Company C acquires 10000 shares in Company D at a price of $5.00 per share.

>C financial asset - investment in C equity instrument

>D equity instrument - C has right to D assets after deducting liability

(c) Company E acquires 100000 call options in Company F

>E financial asset - right to potentially favourable exchange

>F financial liability - obligation to potentially unfavourable exchange

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Financial Asset

- Cash
- An equity instrument of another entity (e.g shares)
- A contractual right to
    - receive cash or another financial asset from another entity (e.g bond, loan receivables, trade receivables)
    - exchange financial instruments with another entity under conditions that are potentially favourable (e.g derivatives)
- A contract to be settled in the entity's own equity instruments in some circumstances.

>does not contain inventories, goodwill,

Summary: financial assets are cash, contractual rights to receivables, derivatives with potentially favourable outcome, or contracts settled in own equity instruments

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Financial Liability

Financial liability refers to a contractual obligation that an entity has to

- A contractual obligation to:
    - deliver cash, or another financial asset (e.g loan payable, finance lease liability, bond (interest + principal)),
    - exchange financial instruments with another entity under conditions that are potentially unfavourable (e.g derivatives)
- A contract to be settled in the entity's own equity instruments in some circumstances. (e.g stock options - variable number of shares in settlement of a fixed dollar value).

Summary: financial liabilities are obligation to give cash or other assets to another entity, derivatives with potentially unfavourable outcomes or a contract to be settled in own equity instrument

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Equity instrument

Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities - no returns guaranteed

Example:

- ordinary share of the company.
    -Voting rights
    -Unguaranteed Dividends
    -Residual Claim
    -High risk (dependent on company performance)
- Preference share (combination of equity and bond)
    -No voting rights
    -Guaranteed dividends
    -Priority upon liquidation
    -Low risk
    -Can be converted to common share

    >naturally preference share liability however become equity upon conversion to ordinary shares

Summary: contract that evidence residual interest in the assets of an entity after deducting all of its liabilities (no obligation to provide returns) - e.g ordinary and preference shares that have been converted to ordinary

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Purpose of Financial Instruments

• manage cash flow

• Use derivatives to hedge risk - minimise risk in the physical market (using derivatives as insurance policies in case price changes unexpectedly - exchange rate, market price)

>e.g corn farmer worried price of corn to go down so they use derivatives to ensure that if it does they still make a return

>e.g cereal makers worried price of corn will go up so they use derivatives to ensure that if it does it won't affect their margins

• Speculating on derivatives – speculation on derivatives is motivated by profit, rather than a desire to mitigate risk.

>e.g investor think primary instrument value will go up so they enter into a derivative that allows them to purchase asset in future at a lower value to resell

Summary: purpose is to manage cash flow, hedge risk associated with primary instruments (exchange rate, market price), and speculate on derivative (make profit)

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Primary instruments

Include cash, receivables, payables and equity securities such as ordinary shares.

Summary:

Primary financial instruments are basic financial assets that hold value on its own

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Derivative financial instruments

Any security whose value is determined by, or derived from, the value of a primary instrument e.g. a share price, bonds, currencies, an interest rate etc.

Summary:

Derivative financial instruments are securities whose value is determined based off a primary financial instrument - creates rights/obligation that transfers risk associated to primary asset

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Option Contract

An option contract is a financial derivative that provides the buyer (holder) with the right, but not the obligation, to buy or sell an underlying asset at a predetermined price within a specified time period.

>The buyer pays a premium to the seller (writer) for this right.

>Call option: allows to buy at strike price (when price expected to increase)

>Put option: allow to sell at strike price (when price expected to decrease)

Summary: right - not obligation - to purchase an asset for a specific price over a specified period at time. Right Purchased for a premium

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Future Contract
Traded on listed exchanges, a futures contract is a standardised agreement between two parties to buy or sell an underlying asset at a predetermined price and date in the future.
>Unlike options futures are an obligation

Summary: obligation to purchase asset at a specific price at a predetermined date (traded on exchange)

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Forwards Contract
Not traded on exchanges between parties, A forwards contract is a customizable agreement between two parties to buy or sell an underlying asset at a specific price and date in the future.
>Unlike options futures are an obligation

Summary: obligation to purchase asset at a specific price at a predetermined date (not traded on exchange - customisable)

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Example Hedging: Financial Instrument
Carey Industries Ltd imports glass from the United States. On 1 January 2019 it acquires glass at a cost denominated in US dollars of $700 000. The amount is payable on 31 March 2019. The current exchange rate is NZ$ 1 = US$ 0.70.

What is the risk to Carey?

> Fluctuations in the exchange rate will change the amount Carey will have to pay on 31 March. If the exchange rate falls to US $ 0.65, then the cost will increase from NZ$1,000,000 to NZ$ 1,076,923

Assuming Carey Industries is concerned about the risk, what could it do?

> Carey could approach a bank and enter into a forward exchange agreement whereby the bank will agree to supply Carey with US$ 700,000 in three months at an agreed rate of (say) 0.68. Carey thus locks in the rate with any deterioration below 0.68 being borne by the bank.
>
> The agreement with the bank is a derivative financial instrument because the financial risks inherent in the “underlying asset” (the currency) drive its value.

Carey would have both a foreign currency receivable and a foreign currency payable with the bank, in addition to the primary (accounts payable) financial instrument.

Summary:

1. **State risk**
2. **State derivative used to mitigate risk e.g option, future, forward**
3. **Explain derivative**
4. **Explain how it affects journal**

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Buyer recognition: Initial recognition [IFRS 9]

An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument (recognised when contract is signed)

Summary: buyers recognise asset/liability associated with a contract when signing a contract

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Issuer recognition: liability vs equity [IAS 32]

Determine liability or equity:

If a financial instrument does not give rise to:

-a contractual obligation on the part of the issuer to deliver cash or another financial asset, or

-to exchange another financial instrument under conditions that are potentially unfavourable,

it is considered to be an equity instrument (no promised return) - else it is a liability.

>no returns or fixed return without profit = equity

>related expense reported based on classification of equity or liability

>Many companies prefer equity as liability negatively affects leverage ratios (increase perceived risk) and some creditors have restrictions on additional debt

Example

- Ordinary Share = equity (no promised returns)
- Preference share unconverted = liability (promised dividends)
- Preference share converted = equity (no promised returns)
- Bond increase = liability (promised principal + interest)

TABLE 7.3 Classification of revenues, expenses and equity distributions		
Statement of financial position classification	Statement of profit or loss and other comprehensive income classification	Statement of changes in equity
Equity instrument		Dividends distributed
Financial liability	Interest expense	
Financial asset	Interest income, dividend income	

Summary: a issuer determines if a contract should be recorded as a entity instrument if no obligation to provide returns (cash, potentially unfavourable derivations) and financial liability if obligation exist
>related expense (dividend, interest) reported based on classification
>preference to report as equity instruments as does not negatively affect financing and leverage ratio

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Example
Bombora Ltd has entered an agreement to provide Rocky Outcrop Ltd with $1 million of shares in Bombora Ltd (based on market value at the time of payment). If the price of the shares was $2.50 at the time the instrument was created, Bombora Ltd would have to provide 400 000 shares if the market price remains static. However, if the market price falls to $2.00, Bombora Ltd would have to provide 500 000 shares.

>This is a financial liability not equity as B enters into a obligation that is potentially unfavourable (R receives $1m regardless - negative impact is number of share by B)

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<u>Issuer recognition: Compound financial instrument</u>
Not all instruments are either liabilities or equity

Convertible notes
Debt Instruments giving the holder the right to convert into the issuer's ordinary shares – containing both a financial liability and an equity component (compound financial instrument) that needs to be recognised on the date the convertible notes are issued
> The debt and equity components are to be measured and disclosed separately on initial recognition (called "split accounting")
> Classification is not revised for convertible notes regardless of change in risk as actions have different motivations (e.g tax implications making profitable conversion unprofitable)

Summary: convertible notes are compound financial instruments (both equity and liability) they allow the holder to convert notes into ordinary share (recognised on date note issued)
>classification unchanged throughout life span until note is converted
>equity and liability recognised separately (split accounting)

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Separate compound financial instrument on initial recognition
The method allocates fair value of the consideration for the compound instrument into its liability and equity components:

Step1: Liability (principal + interest)
Measured at the fair value of a similar liability that does not have an equity conversion option.
This becomes the liability component's carrying amount at initial recognition.

Step 2: Equity (cost of convertible option)
– The equity component is assigned the residual amount
after deducting from the fair value of the instrument the liability component

Summary:
Step 1: Calculate liability portion
PV rate = (period, unconvertible interest rate)
Annuity rate = (period, unconvertible interest rate)
Annual Interest Payment = FV * convertible interest rate

Principle = FV * PV rate
Interest = Annual Interest Payment * Annuity rate
Liability = Principle + Interest

Step 2: Calculate equity portion
Equity = FV - Liability

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Why Is prevailing market interest rate for similar debt is higher than the rate on the convertible notes
Case: 8% on note, 10% interest rate for similar debt without conversion option

The rate of interest on the notes of 8% determines the actual interest paid on the notes and the interest cash flow is used in measuring the liability component of the notes.

However the appropriate rate to use in discounting the cash flows is the rate on the similar "liability only" notes 10% as it is the liability only component of the notes that we are measuring.

The reason that the prevailing market rate for similar debt is higher than the rate on the convertible notes is that holders of the convertible notes are prepared to accept a lower interest rate given the value to them of the alternative to convert the options to ordinary shares at any time up until maturity.

In other words the option has a value which in this case is reflected in a willingness to earn less on the notes than if the notes did not have that option. In a sense the acquirers of the convertible notes have acquired a debt instrument and an option to acquire ordinary shares of the entity and each has a value to them. The accounting reflects that economic position.

Summary: The interest of the convertible note is used to calculate the actual interest on note in the liability component but the interest of non convertible note is used to discount the liability component (principal + interest) as the liability is all we are measuring.
The reason that the rate on non convertible notes are higher than the rate on the convertible notes is that holders of the convertible notes are prepared to accept a lower interest rate given the value to them of the alternative to convert the options to ordinary shares at any time up until maturity (difference is the economic reflection of perceived value of the ability to convert the notes).

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Example
Example 1

Country Road Limited issued $3 million in convertible notes on 1 July 2017. These were issued at their face value and pay interest at 5 %. The interest is paid at the end of each year. The notes may be converted to ordinary shares in Country Road Limited at any time in the 4 years from date of issue. Organisations like Country Road have recently issued similar debt instruments without a conversion option at an interest rate of 7%.

- *Required*:
- Provide the journal entries to:
- Record the issue of the convertible notes at 1 July 2017 in accordance with NZ IAS 32; and
- Recognise the interest payments on 30 June 2018, 30 June 2019, 30 June 2020 and 30 June 2021; and
- Record the accounting entries if all noteholders elected to convert the notes to ordinary shares in Country Road Limited on 30 June 2020.

Step 1: find liability component (principal + interest)

Total face value of convertible bonds = 3000000
Interest = 300000*0.05=150000 (fv * 5%)
Non convertible Interest rate = 7%
Period = 4 years
PV table = 0.76290 (4 years, 7%)
Annuity rate = 3.3872 (4 years, 7%)

Present value of principal = 3000000*0.7629=2,288,700
Present value of interest payment = 150000*3.3872=508000

Liability Component = 2,288,700 + 508,000 = $2,796,700

Step 2: find equity component
Equity Component = Fv-PV=3000000 - 2,796,700 = $203,300

Step 3: generate table

Date	Payment	Interest expense	Increase in bond liability	Bond liability
1 July 2017				2,796,700
30 June 2018	150,000	195,774	45,774	2,842,540
30 June 2019	150,000	198,978	48,978	2,891,518
30 June 2020	150,000	202,406	52,406	2,943,924
30 June 2021	150,000	206,075	56,075	3,000,000

>Interest Expense = outstanding * convertible interest
>Increase in bond liability = Interest Expense - Payment

Step 3: Journal

1 July 2017

Dr	Cash at bank	3,000,000	
Cr	Convertible bonds (liability)		2,796,700
Cr	Convertible bonds (equity component)		203,300

(to record the issue of the convertible bonds and the recognition of the liability and equity components—the equity component, in this case, would be $203,300)

30 June 2018

Dr	Interest expense	195,774	
Cr	Cash		150,000
Cr	Convertible bonds (liability)		45,774

(to recognise the interest expense, where the expense equals the present value of the opening liability multiplied by the market rate of interest; see table that follows)

If the holders elect to convert the options to ordinary shares at the end of the third year of the debentures (after receiving their interest payments), the entries in the third year would be:

30 June 2020

Dr Interest expense 202,406

Cr Cash 150,000

Cr Convertible bonds (liability) 52,406

(to recognise interest expense for the period)

Dr Convertible bonds liability 2,943,924

Dr Convertible bonds (equity component) 203,234

Cr Share capital 3,147,158

(to recognise the conversion of the bonds into shares of Country Road Ltd)

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Example 2

Question 2: Financial Instruments

Your friend Zena is a junior accountant for Barber Limited and has approached you – as a specialist in financial instruments – to advise her on some accounting matters with regards to convertible notes that Barber Limited has recently issued. She provides the following information:

> "We issued 500 convertible notes on 1 April 2019. The notes have a six-year term and were issued at a face value of $1,000 per note. We pay interest on the notes at 8% annually in arrears. The holder of each note is entitled to convert the note into 100 ordinary shares of Barber Limited at any time up to maturity."

She also tells you that when the notes were issued, the prevailing market interest rate for similar debt (similar term, similar credit status and similar cash flows) without the conversion options was 10%.

Finally she tells you that the noteholders are considering their conversion options and Zena is interested in understanding the accounting for the conversion.

Barber Limited has a balance date of 31 March.

Working:

NZ IAS 32 requires compound equity instruments to be disclosed as part equity and part liability. In considering how to measure the liability and equity components of the convertible notes we determine the present value of the cash flows at the market's required rate of return on a similar debt instrument without the conversion option of 10%. This calculated amount will represent the liability component of the convertible notes. The difference

between the liability component and the total issue price of the notes will represent the equity component.
We can identify the present value of the six year notes and then allocate the difference between the present value of these notes and the issue price of $500,000 (500 x $1,000) to the equity component.

Fair value = 500000
Interest = 10%
Period = 6 years
Interest = 40000 (500000*0.08)
Principal interest = 0.5645
Implicit rate = 4.3553

PV of principal = 500000 * 0.5645 = 282250
PV of interest payments = 40000*4.3553=174212

Total PV = 282250+174212=456,462
Equity Component = 500000-456,462=43538

Date	Payment	Interest expense	Increase in Notes Liability	Notes liability
1-Apr-19				456,462
31-Mar-20	40,000	45,646	5,646	462,108
31-Mar-21	40,000	46,211	6,211	468,319
31-Mar-22	40,000	46,832	6,832	475,151
31-Mar-23	40,000	47,515	7,515	482,666
31-Mar-24	40,000	48,267	8,267	490,933
31-Mar-25	40,000	49,093	9,093	500,026*

The journal entries she would need to make to:
(i) Record the issue of the convertible notes at 1 April 2019;
1 April 2019
DR Cash 500000
CR Convertible notes liability 456462
CR Option to convert note liability (equity) 43538
>To record the issue of the convertible notes and the recognition of the liability and equity components.

(ii) Recognise interest on the convertible notes at 31 March 2020; and

31 March 2020
DR Interest expense 45646
CR Cash 40000
CR Convertible notes liability 5646
>To recognise the interest expense, where the expense equals the present value of the opening
liability multiplied by the market rate of interest

(iii) Record the conversion of the notes into ordinary shares assuming that all noteholders elected to convert at the end of the second year (i.e. 31 March 2021).
DR convertible note liability 468319
DR Option to convert note liability (equity) 43538
CR Share Capital 511857
>To recognise the conversion of the convertible notes to ordinary shares

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