Surf’s up!
Are you ready for the next wave of NZ IFRS standards?
November 2016
Accounting changes are just around the corner

As we enter 2017, many New Zealand businesses will soon pass the date of initial application of a series of significant accounting standards (see the diagram below). Is your business ready for the next wave of accounting changes?

In July 2014, the long-awaited new revenue recognition standard, NZ IFRS 15 Revenue from Contracts with Customers, was issued. This standard provides a single revenue recognition model based on the transfer of control of a good or service to a customer.

The final version of NZ IFRS 9 Financial Instruments was issued shortly afterwards, which introduces new requirements for accounting for financial instruments.

Finally, in early 2016, NZ IFRS 16 Leases was issued. The new leases standard introduces fundamental changes to lessee accounting, by requiring lessees to recognise most leases on their balance sheets as lease liabilities with corresponding right-of-use assets.

NZ IFRS 16 will become effective a year after NZ IFRS 9 and NZ IFRS 15, however, these three NZ IFRS standards should be addressed together in implementation projects to minimise disruption to business processes and to assess their collective impact.

What is more, understanding and preparing for these new standards sooner rather than later can reduce the risk of undesirable outcomes of their adoption. This includes providing your stakeholders with explanations about different balance sheets and income statements, and negotiating any necessary changes to compensation arrangements, borrowing covenants and other contractual arrangements linked to financial metrics in your financial statements.

This publication summaries the requirements of NZ IFRS 9 that are relevant for corporates (i.e., entities other than banks or other financial institutions) and discusses the most significant impacts of the new standard on these entities. The publication also outlines a summary of NZ IFRS 15 and NZ IFRS 16, and practical implications of adoption of new accounting requirements.

We trust you will find the publication useful in understanding and implementing the new standards. We encourage you to contact one of our EY Assurance partners or a member of the EY Financial Accounting Advisory Services team to discuss ways in which we can help you adopt the new NZ IFRS standards. In the back of this publication, you will find our contact details.
Financial instruments: NZ IFRS 9

What you need to know

While the introduction of a new standard on financial instruments has the greatest effect on banks and other financial institutions, businesses in other industry sectors should not underestimate the impact of adopting NZ IFRS 9. This includes:

- Amended guidance on the classification and measurement of financial assets. The classification of financial assets will depend on their nature and how they are managed. More complex financial assets will need to be recorded at fair value, but there will no longer be a requirement to separate derivatives embedded in financial assets.

- For those financial assets measured at amortised cost rather than fair value, the new impairment requirements may have a significant impact on longer-term receivables (including intragroup loans to an entity's parent or sister entities), assets relating to long-term customer contracts and debt securities.

- The new hedge accounting model is less rules-based than the model set out in NZ IAS 39 and should enable a wider range of economic hedging strategies to achieve hedge accounting. There are, however, significant disclosure requirements to help communicate these risk management activities to users of the accounts.

Classification and measurement

Financial assets:

- Classification of financial assets under NZ IFRS 9 is based on both the use of assets within an entity's business model and the nature of the contractual cash flows.

- Similar to NZ IAS 39, NZ IFRS 9 provides guidance on how a particular category of financial assets should be measured (at amortised cost or fair value) and how the related gains and losses should be presented (in profit or loss or in other comprehensive income).

- A new optional classification category for certain equity instruments, fair value through other comprehensive income (FVOCI), was introduced. If selected, all movements in fair value for these assets will be recorded in other comprehensive income instead of profit or loss.

- Entities therefore need to assess if their existing accounting treatment continues or changes are needed.

The table below shows the measurement requirements and gains/losses presentation for typical financial assets:

<table>
<thead>
<tr>
<th>Financial assets</th>
<th>Subsequent measurement</th>
<th>Presentation of gains/losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Many simple debt instruments (e.g. trade receivables and basic loans to other entities)</td>
<td>Continue to be carried at amortised cost</td>
<td>In profit or loss (e.g. impairment losses)</td>
</tr>
<tr>
<td>More complex debt instruments (e.g. convertible bonds)</td>
<td>Measured at fair value</td>
<td>In profit or loss</td>
</tr>
<tr>
<td>Derivatives</td>
<td>Measured at fair value</td>
<td>In profit or loss*</td>
</tr>
<tr>
<td>Equity instruments that are held for trading</td>
<td>Measured at fair value</td>
<td>In profit or loss</td>
</tr>
<tr>
<td>Equity instruments (e.g. shares in other entities, including shares in unlisted entities) designated at FVOCI</td>
<td>Measured at fair value</td>
<td>In other comprehensive income</td>
</tr>
</tbody>
</table>

* If hedge accounting is not applied.

Financial liabilities:

The only change in respect of financial liabilities is that for those designated at fair value through profit or loss, fair value changes attributable to own credit risk are presented in other comprehensive income instead of profit or loss.
Impairment

• NZ IFRS 9 introduces a new ‘expected credit loss’ (ECL) impairment model which replaces NZ IAS 39’s incurred loss model.

• The new model applies to financial assets measured at amortised cost, some types of debt instruments measured at fair value, financial guarantees, loan commitments, lease receivables and assets arising from customer contracts (as defined in NZ IFRS 15).

• Under the NZ IFRS 9’s general approach, impairment losses will ordinarily be recognised on initial recognition as a 12-month expected loss allowance and move to a lifetime expected loss allowance if there is a significant deterioration in credit risk.

• Earlier recognition of impairment losses means entities need to consider whether existing processes and systems have adequate capacity to identify the significant increase and decrease in credit risk.

The table below shows the approaches under the new impairment model for typical financial assets

| Most trade receivables, contact assets within the scope of NZ IFRS 15 that do not contain a significant financing component | Simplified approach, under which the impairment losses are measured equal to lifetime expected losses |
| Most loans, debt securities, loan commitments and financial guarantee contacts | General approach (more complex approach), under which the 12-month loss allowances are recognised on initial recognition of assets |
| Trade receivables and contact assets that do contain a significant financing component, as well as lease receivables | An accounting policy choice – either simplified or general approach |

Hedge accounting

• NZ IFRS 9 aims at simplifying the existing hedge accounting rules.

• The standard also aims to reflect how an entity manages its risk and the extent to which hedging mitigates those risks.

• What is more, more risks can be hedged under new NZ IFRS 9. This will be particularly helpful for New Zealand businesses selling commodities or where commodity inputs (such as fuel) are a significant cost to the business.

The table below shows some advantages, neutral impacts and disadvantages of the new hedge accounting rules

<table>
<thead>
<tr>
<th>Advantages</th>
<th>No change or neutral impact</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Ability to hedge components of risk such as the oil component of ship fuel purchases</td>
<td>• Hedge documentation required at inception</td>
<td>• Must continue hedge accounting if the qualifying criteria still met: voluntarily de-designation of hedging relationship is prohibited if risk management objective remains the same</td>
</tr>
<tr>
<td>• Less volatility in profit or loss due to the exclusion of time value of options, forward points of forward contacts and FX basis spread</td>
<td>• 3 types of hedge relationships remain the same</td>
<td>• Disclosure (NZ IFRS 7) is more onerous</td>
</tr>
<tr>
<td>• Elimination of the 80-125% quantitative threshold for recognising effectiveness</td>
<td>• Ineffectiveness is still measured and booked</td>
<td></td>
</tr>
<tr>
<td>• No retrospective effectiveness testing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Expanded ability to hedge net positions/hedge layers of hedged items in fair value hedges</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

How we see it

The relaxation of hedge accounting requirements presents entities with an opportunity to reassess whether it would be beneficial to adopt hedge accounting in some areas. In making this assessment, management should also consider whether their existing systems have sufficient capability to support the new requirements.
The new revenue standard

Top line, proceeds, turnover – the list of synonyms goes on. This fact alone spells out the importance of revenue for most, if not all, businesses. No wonder the new revenue standard is – or should be – on the agenda of the majority of New Zealand companies.

What you need to know

• NZ IFRS 15 creates a single source of revenue accounting requirements for all entities in all industries. The new revenue standard is a significant change from current NZ IFRS.

• NZ IFRS 15 is principles-based, consistent with current revenue requirements, but provides much more application guidance.

• The new standard will have little effect on some entities, in terms of their reported revenue amounts, but arriving at that outcome may require considerable resources on adoption of the new standard to confirm that their current accounting treatment continues to be appropriate under the new standard and to meet new disclosure requirements.

• The new standard will require significant changes for others, especially those entities for which current NZ IFRS provides little application guidance.

• NZ IFRS 15 also specifies the accounting treatment for certain items not typically thought of as revenue, such as certain costs associated with obtaining and fulfilling a contract and the sale of certain non-financial assets.

The five step model

The core principle of the new standard is based on the fulfillment of the entity’s promises made in contracts with its customers to provide goods or services (referred to as “performance obligations”). More specifically, the new standard requires that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Entities achieve this core principle by applying the five-step model which is outlined below.
What is the impact for your entity?

The impact of adoption of the new revenue standard depends on the size of an entity and complexity of its contractual arrangements with customers.

The following areas of your entity’s operations are more likely to be significantly impacted by the requirements of the new standard:

- Long-term contracts, particularly those still incomplete at the time of NZ IFRS 15 becoming effective.
- Contracts with multiple deliverables, including bundled offers.
- Variable consideration, deferred payment terms or amounts paid or payable to customers.
- Costs incurred to obtain and/or fulfil the contract.
- Changes in the contract throughout its term.
- Revenue from royalties and licencing.

Entities operating in some sectors are likely to be impacted more than others, such as

- Telecommunication.
- Building and Construction.
- Consumer Product & Retail.
- IT, Software and Cloud based services.

Transition challenges

As entities embark on the journey to transition to the new revenue recognition rules, they need to be mindful of numerous traps and pitfalls. Each step of the way may present additional challenges and with most requirements being entity-specific and, at times, contract-specific, there could be little or no information readily available to make significant judgments required by NZ IFRS 15.

Listed below are some of the more common challenges faced by EY’s clients already deep in the process of adopting NZ IFRS 15.

<table>
<thead>
<tr>
<th>Identify contracts</th>
<th>Identify performance obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Identifying all contracts that are subject to the new revenue recognition standard</td>
<td>• Identifying all performance obligations associated with a contract</td>
</tr>
<tr>
<td>• Excluding contracts that are not subject to the revenue recognition standard</td>
<td>• Tracking performance obligations associated with a contract</td>
</tr>
<tr>
<td>• Determining when to combine or separate contracts with the same counterparty</td>
<td>• Updating performance obligations for contract modifications</td>
</tr>
<tr>
<td></td>
<td>• Capturing performance obligations established by customary business practice</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Determine/allocate transaction price</th>
<th>Recognise revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Reflecting all forms of consideration in the calculated transaction price</td>
<td>• Not recognising revenue before a performance obligation has been satisfied</td>
</tr>
<tr>
<td>• Estimating accurate standalone selling prices for pricing allocation purposes</td>
<td>• Recognising revenue when a performance obligation has been satisfied</td>
</tr>
<tr>
<td>• Allocating the transaction price to performance obligations</td>
<td>• Measuring when a performance obligation for a contract has been satisfied or partially satisfied</td>
</tr>
<tr>
<td>• Updating transaction prices and their allocation for contract modifications</td>
<td>• Identifying the difference between billing and revenue to be recognised</td>
</tr>
</tbody>
</table>

How we see it

Each entity is unique in its ways of dealing with customers. As such, there is no one-approach-fits-all for transition. In EY’s experience, the most effective way to assess readiness of your entity is to apply NZ IFRS 15 revenue recognition rules to a sample of contracts that represents major lines of your business.
Leases

What you need to know

NZ IFRS 16 requires lessees to recognise most leases on their balance sheets. The new standard is a significant change in approach from current NZ IFRS and will affect many entities across various industries. Some changes under the new standard include:

- Lessees will have a single accounting model for all leases, with two exemptions (low value assets and short term leases).
- Lessor accounting is substantially unchanged.
- There will be additional disclosure requirements.

Determining whether an arrangement contains a lease

Under the new standard, a lease is a contact, or part of a contract, that convey the rights to use an assets (the underlying assets) for a period of time in exchange for consideration. To be a lease, a contract must convey the use of an identified asset, which could be a physically distinct portion of an asset such as a floor of a building.

A contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to:

- Obtain substantially all of the economic benefits from the use of the identified asset.
- Direct the use of the identified asset (i.e., direct how and for what purpose the asset is used).

Lessee accounting: recognition and measurement

<table>
<thead>
<tr>
<th>Initial recognition and measurement</th>
<th>Measure right of use (ROU) asset(^1) and lease liability at present value of lease payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsequent measurement</td>
<td>Depreciate ROU asset based on NZ IAS 16, or use alternative measurement basis under NZ IAS 16 and NZ IAS 40</td>
</tr>
<tr>
<td>ROU Asset</td>
<td>Accrue liability based on the interest method, using a discount rate determined at lease commencement(^2). Reduce the liability by payments made</td>
</tr>
<tr>
<td>Liability</td>
<td>Generally front loaded expense for an individual lease. Interest and depreciation are separated</td>
</tr>
</tbody>
</table>

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1. Initial measurement of the ROU asset would also include: the lessee's initial direct costs; prepayments made to the lessor less any lease incentives received from the lessor; and restoration, removal and dismantling costs.
2. With some exceptions.
What is the impact for lessees?

Financial statement impact – before and after NZ IFRS 16

The following tables illustrate the impacts of adoption of NZ IFRS 16 on the financial statements of lessees:

<table>
<thead>
<tr>
<th>Balance sheet impact*</th>
<th>NZ IAS 17</th>
<th>NZ IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Finance leases</td>
<td>Operating leases</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$SSSS</td>
<td>$SSSS</td>
</tr>
<tr>
<td>Off balance sheet rights / obligations</td>
<td>$SSSS</td>
<td></td>
</tr>
</tbody>
</table>

* IASB - NZ IFRS 16 Effects analysis

<table>
<thead>
<tr>
<th>Income statement Impact*</th>
<th>NZ IAS 17</th>
<th>NZ IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$SSS</td>
<td>$SSS</td>
</tr>
<tr>
<td>Operating costs (excluding depreciation and amortisation)</td>
<td>$SSS</td>
<td>Single lease expense</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$SSS</td>
<td>$SSS</td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
<td>Depreciation</td>
<td>Depreciation</td>
</tr>
<tr>
<td>Operating profit</td>
<td>$SSS</td>
<td>$SSS</td>
</tr>
<tr>
<td>Finance costs</td>
<td>Interest</td>
<td>Interest</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>$SSS</td>
<td>$SSS</td>
</tr>
</tbody>
</table>

* IASB - NZ IFRS 16 Effects analysis

What are the practical implications for lessors?

The accounting by lessors is substantially unchanged from current accounting. However, lessors should understand how the new standard could affect their lessee-customers’ behaviour. This would help lessors negotiate lease arrangements that meet the needs of their customers. For example, certain lessees may desire shorter lease terms or a larger portion of variable payments in an effort to minimise their financial statement impact. However, shorter leases and variable payments could result in unpredictable revenue for lessors and drive up costs to lessees. Lessees may request that lessors assist them by separately pricing non-lease components to help them to evaluate and minimise the financial statement impact. However, lessors may be reluctant to disclose this information for proprietary reasons. Although a contractually stated price may be the stand-alone price for a good or service, it is not presumed to be for accounting purposes.
Industry impact – entities most likely to be affected

The effects of NZ IFRS 16 will need to be assessed on the facts and circumstances relevant to each entity. This will further be impacted by the different capital structures that entities have adopted, for example an entity that typically rents office space, which is being accounted for as an operating lease, will be more significantly impacted than an entity that has purchased office space.

It is expected that certain industries will be more significantly impacted than others. Some of the types of contracts that entities would need to consider include:

- **Retail and consumer product entities** are expected to be most significantly impacted by the changes in the new lease requirements. This is especially the case where leased retail space forms a significant part of the entity's business model. In addition, manufacturing entities will need to consider all the major contracts that they have entered into, such as the rental of manufacturing plants and equipment, distribution centres as well as fleet arrangements that form part of their distribution networks.

- **Telecommunications entities** are expected to be significantly impacted by the new lease requirements. Careful consideration would need to be given to the new definition of a lease to identify arrangements that contain a lease (previously NZ IFRIC 4). Telecommunications will need to consider tower arrangements, signal transmission devices as well as data and fixed line agreements (for example, indefeasible right of use (IRU) on fibre lines). Some of these entities have extensive retail outlets, which will require consideration.

  In addition, telecommunication entities will need to analyse contracts where equipment is provided to their customers. In such instances, consideration would need to be given to whether the contract contains a lease and, if so, how the lease payments should be allocated to products and services provided.

- **Banking and other financial services entities** that have extensive branch networks as well as large administration and call centres will need to consider any lease arrangements carefully. In addition, contracts over ATMs and the related space occupied by such machines will need to be assessed under the new lease standard's requirements. Financial services entities may also make use of data storage facilities and these arrangements with providers could potentially fall within the scope of NZ IFRS 16. Financial service entities will need to monitor how right-of-use assets will be treated for regulatory capital requirements.

- **Metals and mining entities** will need to carefully consider all major arrangements that they have entered into that may give rise to on balance sheet lease accounting under the new leases standard, such as mining equipment, vehicles, as well as land and buildings. Mining entities often enter into arrangements that contain a lease (previously NZ IFRIC 4) that falls within the scope of the new standard.

  Similarly, **construction and engineering entities** will need to consider all major arrangements that they have entered into such as leases over construction equipment, vehicles, as well as land and buildings, which may give rise to on balance sheet lease accounting under the new leases standard.

- **Oil and gas entities** may be impacted by arrangements in respect of land and buildings, vehicles and equipment as well as arrangements that contain a lease (previously NZ IFRIC 4).

- **Insurance entities** will need to consider all major arrangements entered into in respect of land and buildings, vehicles and equipment that are not currently accounted for on balance sheet.
How can EY help?

Based on EY's experience the most effective approach to projects on implementation of new standards is to proceed step-by-step and involve a wide range of functions, including accounting, tax, systems and IT professionals.

We have deep experience in new accounting standards' implementation and have developed insights on different aspects of the major changes, both global and local, for the new NZ IFRS standards.

We can support your organisation through any and all stages of the project using our experience and various proprietary tools.

We approach transition to the new standards in practical steps ...

<table>
<thead>
<tr>
<th>Workstreams</th>
<th>Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diagnostic</td>
<td>Identification of accounting, reporting and tax differences and consequences on business processes and IT systems</td>
</tr>
<tr>
<td>Design and planning</td>
<td>Set up project infrastructure and management, including roadmap and change management strategy</td>
</tr>
<tr>
<td>Solution development</td>
<td>Identify solutions, prepare implementation plan and develop solutions across workstream</td>
</tr>
<tr>
<td>Implementation</td>
<td>Approve and roll out solutions across workstreams</td>
</tr>
<tr>
<td>Post implementation</td>
<td>Address deferred items and transition to operational model</td>
</tr>
</tbody>
</table>

... so you stay in control from the beginning to the end.

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