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IFRS for SMEs
Section 12 *Other Financial Instruments Issues*
Section 22 *Liabilities and Equity*

Presenter:
Anton van Wyk M. Com CA (SA)

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Presenter

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Anton van Wyk M. Com CA (SA)

Anton van Wyk is a **chartered accountant** and independent consultant in International Financial Reporting Standards (IFRS and IFRS for SMEs). As former subject head of Financial Accounting at various higher education providers (including the University of Johannesburg and Monash University South Africa), he has gained valuable insights into and understanding of the important principles underlying the International Financial Reporting Standards (IFRS). Anton is a well-known and popular presenter who has presented numerous IFRS updates for several accounting bodies across South Africa. He is known for his ability to simplify and highlight the most important principles contained in IFRS, whilst keeping the learning process enjoyable for attendees.

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Welcome to the Webinar

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Welcome to this webinar dealing with **Section 12 *Other Financial Instruments Issues*** and **Section 22 *Liabilities and Equity*** in the **IFRS for SMEs**

Agenda – points to cover in the webinar

1. Introduction to Section 12 and brief revisit of Section 11
2. Section 12 *Other Financial Instruments Issues*
3. Section 22 *Equity and Liabilities*
4. Conclusion

IFRS for SMEs

Section 12 *Other Financial Instruments Issues*

Introduction to Section 12 and brief revisit of Section 11

Scope of Sections 11 and 12

- S11 and s12 together deal with recognition (including derecognition), measurement and disclosure of financial instruments

SECTION 11	SECTION 12
Basic financial instruments	More complex financial instruments
Relevant to ALL entities with financial instruments	Must be considered to ensure correct inclusion or exclusion from scope

Accounting policy choice (S11 & S12)

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- An entity with financial instruments, shall CHOOSE to apply either:

  - Sections 11 and 12 in IFRS for SMEs in FULL; **or**
  - IAS 39 *Financial Instruments: Recognition and Measurement* (in full IFRSs) plus the disclosure requirements of Sections 11 and 12 of IFRS for SMEs

- The above choice is an accounting policy choice!

- Section 10 *Accounting Policies, Estimates and Errors* in IFRS for SMEs will apply to changes in accounting policies! Make sure a change made qualifies as a change in accounting policy!

What are basic FI's? (S11)

- (a) Cash
- (b) A debt instrument that meets the *prescribed conditions*
- (c) A commitment to receive a loan that:
  - (i) cannot be settled NET in cash; and
  - (ii) when the commitment is executed, is expected to meet the *prescribed conditions*
- (d) An investment in non-convertible preference shares and non-puttable ordinary shares or preference shares

What is a financial instrument (FI)?

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- A contract (NB)
- That gives rise to a financial asset of one entity and
- A financial liability or equity instrument of another entity

Only FA's and FL's are financial instruments!

Initial recognition – when? (S11)

- Financial assets (FA's) or financial liabilities (FL's) shall be initially recognised ONLY when the entity becomes a party to the contractual provisions of the instrument
- Legal form prevails…

Initial measurement (S11)

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- When a FA or FL is recognised initially (i.e. at FIRST recognition), the entity shall measure the FI at its **transaction price**
  - Transaction costs are usually included in the transaction price…
  - If the FA or FL is subsequently measured at fair value through profit or loss, the transaction costs are expensed at initial recognition through profit or loss
- If the arrangement/agreement, <u>in effect</u>, constitutes a financing transaction, the FA or FL shall be measured at the **present value of the future payments** discounted at a market rate of interest for <u>similar debt</u>
  - This is normally evident in:
    - Interest-free financing
    - Financing below market-related terms

Most FI's ito S11 of IFRS for SMEs will initially be measured at the transaction price

Initial measurement – summary (S11)

FI terms market-related?

YES

Measure initially at transaction price

NO

‘Implicit’ financing element in sales/ purchase transaction

Measure at **cash** price

If not available:

Other debt instrument

Measure initially at PV of future cash flows using I% of **similar** debt

Subsequent measurement of FI's (S11)

- Debt instruments that satisfy prescribed conditions
  - Amortised cost, using the effective interest method
- Debt instruments classified as current assets or current liabilities
  - Undiscounted amount of cash or other consideration expected to be paid or received, net of impairment where appropriate
  - Unless the arrangement constitutes a financing transaction: PV of future payments discounted at a market-related interest rate for similar debt instrument
- Commitments to receive a loan: at cost, which could be zero
- Investments in non-convertible preference shares or non-puttable ordinary or preference shares:
  - If traded publicly or fair value can be reliably measured: @FVTPL;
  - Otherwise at cost less impairment

IFRS for SMEs

Section 12 *Other Financial Instruments Issues*

Overview of main areas in S12

- Scope
  - Section 11 versus section 12?
  - Accounting policy choice (IFRS for SMEs versus full IFRSs (IAS 39))
  - More complex financial instruments
- Initial recognition
- Initial measurement
- Subsequent measurement
  - Fair value through profit or loss
- Impairment of financial instruments measured at cost or amortised cost
- Derecognition of financial assets and financial liabilities
- "Hedge accounting"
- Disclosures

Examples of financial instruments

- **WITHIN THE SCOPE OF SECTION 12 OF THE IFRS FOR SMEs**
- Asset-backed securities (e.g. securitised receivables)
- Options
- Rights
- Warrants
- Futures and forward contracts
- Interest rate swaps that can be settled net in cash
- Designated and qualifying hedging instruments
- Commitments to make a loan to another entity
- Commitments to receive a loan where the commitment can be settled net in cash

Complex instruments

Specific scope exclusions (S12)

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- Similar to Section 11
- Interests in subsidiaries, associates and joint ventures
- Employers' rights and obligations under employee benefit plans
- Leases
- FI's that meet the definition of an entity's own equity instruments

- Unique to Section 12
- FI's covered by Section 11
- Rights under insurance contracts
- Contracts for contingent consideration in a business combination

Unique scope considerations (S12)

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- **Basic principle:** contracts to buy or sell a **non-financial item** (such as PP&E, a commodity, inventory, intangible asset etc.) are EXCLUDED from section 12 as the contracts are not financial instruments

- **Exception:** Contracts to buy or sell a **non-financial item** will be INCLUDED in section 12 if the contract **can** be settled:
  - Net in cash or another financial instrument; or
  - By exchanging financial instruments as if the contracts were financial instruments;
  - Except for: contracts that were entered into and continue to be held for the purpose of the physical receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements = these contracts shall be excluded from the scope of section 12

Unique scope considerations (S12)

- **Example**
- Company A (Pty) Ltd is the holder of an option to acquire a machine from Company B (Pty) Ltd at R300 000.
  - The option contract is NOT within the scope of section 12 as it is not a financial instrument (reason: machine = PP&E = non-financial item, hence option relates to a non-financial item)
  - If the option can be settled net in cash (i.e. company A (Pty) Ltd can demand from the option giver payment of the difference between the market value of the machine and R300 000 at maturity date of the option), the option contract **IS** within the scope of section 12 as it is now a speculative instrument (i.e. risk, underlying is potentially irrelevant)
  - If the option can be settled net in cash, but company A (Pty) Ltd entered into the option and continues to hold the option for the purpose of the *physical delivery* of the machine in terms of company A (Pty) Ltd's expected purchase, sale or usage requirements, the option contract **IS NOT** within the scope of section 12 (reason: its purpose is not speculation)

Unique scope considerations (S12)

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- Section 12 applies to all contracts that impose risks on the buyer or seller that are not typical of contracts to buy or sell tangible items

- *For example: this section applies to contracts that could result in a loss to the buyer or seller as a result of contractual terms that are unrelated to changes in the price of the non-financial item, changes in foreign exchange rates or a default by one of the counterparties*

- **Crux: Be on the lookout for unusual contract terms that can cause unusual losses to the buyer/seller of the non-financial item…**

Initial recognition (S12)

- Same as section 11

Initial measurement (S12)

- FA's or FL's shall be **initially measured at its fair value**, which is normally the transaction price
- *Section 11: measure initially at transaction price (look out for unusual interest arrangements, then at PV of future cash flows)*
- **Section 12:**
  - Transaction costs shall NOT be included in the initial measurement of FI's, as the subsequent measurement is at FVTPL
  - If payment for an asset is deferred or is financed at a rate of interest that is not a market rate, the entity shall initially measure the asset at the present value of the future payments discounted at a market rate of interest

Subsequent measurement (S12)

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- At the end of each reporting period, an entity shall measure all FI's within the scope of section 12 **at fair value** and recognise **changes in fair value in profit or loss**, <u>except</u> as follows:

  - Equity instruments that are not publicly traded and whose fair values cannot be reliably measured (and all contracts linked to such instruments that, if exercised, will result in delivery of such instruments), shall be measured at **cost less impairment**

- **"Amortised cost" does <u>not</u> feature within section 12…**

- At the date that the fair value can no longer be measured/estimated reliably, its carrying amount (as at the last date the asset was reliably measured at fair value) becomes its new cost

- The FA will be measured at **cost less impairment,** until a reliably measured fair value becomes available again

Impairment of FI's (at cost) (S12)

- Same as section 11

Derecognition of FA's and FL's (S12)

- Same as section 11

“Hedge accounting” (S12 only)

- Special set of rules to account for <u>designated</u> hedging instruments and hedged items/risks

- Certain requirements have to be met before hedge accounting can take place

- **Hedge accounting permits the gain or loss on the <u>hedging instrument</u> and on the <u>hedged item/risk</u> to be recognised in profit or loss <u>at the same time</u>**

Requirements for hedge accounting

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- **<u>ALL</u>** of the following criteria must be complied with:
  - The entity <u>designates and documents</u> the hedging relationship (risk being hedged, hedged item, hedging instrument is clearly identified)
  - The <u>hedged risk</u> is a qualifying hedged risk specified in the IFRS for SMEs
  - The <u>hedging instrument</u> is a specified hedging instrument specified in the IFRS for SMEs
  - The entity expects the hedging instrument to be <u>highly effective</u> in offsetting the designated hedged risk *("hedge effectiveness" is the degree to which changes in fair value or cash flows of the hedged item that are attributable to the hedged risk, are offset by changes in fair value or cash flows of the hedging instrument)*

Qualifying hedged items/risks

- **Interest rate risk** of a debt instrument measured at amortised cost (not foreign exchange risk: forex gains or losses on hedged item already in P/L (s30) and forex gains or losses on hedging instrument too = therefore effect of hedge accounting is immaterial)

- **Foreign exchange risk** OR **interest rate risk** in a firm commitment or a highly probable forecast transaction

- **Price risk** of a commodity it holds, or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity

- **Foreign exchange risk** in a net investment in a foreign operation

Qualifying hedging instruments

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- Interest rate swap, foreign currency swap, foreign currency FEC, commodity FEC that is expected to be **highly effective** in offsetting a qualifying risk that is designated as the hedged risk
- It involves a **party external to the reporting entity** (i.e. external to the group, segment or individual entity being reported on)
- Its **notional amount** is equal to the designated amount of the principal/notional amount of the hedged item
- It has a **specified maturity date**, not later than:
  - The maturity date of the hedged item;
  - The expected settlement of the commodity purchase or sale commitment; or
  - The occurrence of the highly probably forecast transaction being hedged.
- It has **no prepayment, early termination or extension** features

Hedge type 1: fair value hedge

- **Fair value hedge** hedges the risk of changes in the fair value of:
  - recognised financial instruments (e.g. interest rate risk on fixed interest rate loans) or
  - commodities held (price risk)

- Examples of **hedging instrument** used to hedge designated hedged item's risk:
  - Interest rate swap (swap fixed rate for variable interest rate)
  - Acquisition of put ("sell") option on commodities

Hedge type 1: fair value hedge (2)

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- Changes in the fair value of FAIR VALUE hedges **(hedging instrument)**, are **accounted for in profit or loss** and the hedging instrument (e.g. interest rate swap or put option) as an asset or liability in the statement of financial position

- The changes in the fair value of the **hedged item** are also recognised in profit or loss and an adjustment is made to the carrying amount of the hedged item

- If hedge accounting is **discontinued** and the hedged item is an <u>asset or liability carried at amortised cost</u> and has not been recognised, any fair value adjustments (gains/losses) recognised as adjustments to the CA of the hedged item are amortised into profit or loss using the effective interest method over the remaining life of the hedged item

Hedge type 1: fair value hedge (3)

- Hedge accounting is **discontinued** if:
  - The hedging instrument expires or is sold or terminated;
  - The hedge no longer meets the requirements of hedge accounting; or
  - The entity revokes the designation

Example: fair value hedge of a FC

- Example 1: Foreign firm commitment (FFC) hedged by **fair value hedge**

- Company A (Pty) Ltd places a non-cancellable order for inventory on 20 January 2020 to the value of $100 000. The inventory is delivered on 29 February 2020. Company A's reporting date is 31 March 2020, at which date the foreign creditor is still unsettled and 40% of the inventory acquired in this transaction had been sold. The foreign creditor is settled at 30 April 2020. Company A (Pty) Ltd took out a hedge (foreign exchange FEC) on 20 January 2020 to cover the payment of the creditor on 30 April 2020 at S1 = R9.80. Company A (Pty) Ltd complies with **all** hedging criteria, except that hedge effectiveness must be assessed on an ongoing basis.
- The spot rates and FEC rates for similar FEC's than Company A (Pty) Ltd's FEC, are as follows:

	Spot rate	FEC rate
20 January 2020	$1 = R9.50	$1 = R9.80
29 February 2020	$1 = R9.75	$1 = R10.00
31 March 2020	$1 = R9.90	$1 = R10.22
30 April 2020	$1 = R9.98	$1 = R10.30

Example (continued)

- <u>Solution</u>
- 20 Jan 2020 – no journal entries as no transaction date and hedge fair value = 0
- <u>29 Feb 2020 (transaction date)</u>
- *Effectiveness assessment*
  - Gain on hedge: $100 000 x (R10.00 – R9.80) = <u>R20 000</u>
  - Loss on transaction: $100 000 x (R9.75 – R9.50) = R25 000 = **80%** = effective
- *Journal entries (FC = firm commitment)*

	Dr	Cr
Dr Forex loss (P/L)	R25 000	
Cr FC Liability		R25 000
Dr FEC Asset	R20 000	
Cr Hedging gain (P/L)		R20 000
Dr Inventory ($100k x R9.75)	R975 000	
Cr Foreign creditor		R975 000
Dr FC Liability	R25 000	
Cr Inventory		R25 000

Example (continued)

- 31 March 2020 (year-end)

- *Effectiveness assessment*
  - Gain on hedge: $100 000 x (R10.22 – R9.80) = R42 000
  - Loss on transaction: $100 000 x (R9.90 – R9.50) = R40 000 = **105%** = effective

- *Journal entries*
  - Dr Forex loss (P/L) (R40 000 – R25 000 before) R15 000
  - Cr Foreign creditor R15 000

  - Dr FEC Asset (R42 000 – R20 000 before) R22 000
  - Cr Hedging gain (P/L) R22 000

  - Dr Cost of sales (40% x (R975 000 – R25 000)) R380 000
  - Cr Inventory R380 000

Example (continued)

- 30 April 2020 (settlement date)

- *Effectiveness assessment*
  - Gain on hedge: $100 000 x (**R9.98** – R9.80) = R18 000
  - Loss on transaction: $100 000 x (R9.98 – R9.50) = R48 000 = **37.5%** = ineffective

- *Journal entries*
  - Dr Forex loss (P/L) (R48 000 – R15 000 – R25 000) R8 000
  - Cr Foreign creditor R8 000

  - Dr For. creditor (R975k + R15k + R8k) or ($100k x R9.98) R998 000
  - Cr Bank R998 000

  - Dr Fair value loss (P/L) (R18 000 – R22 000 – R20 000) R24 000
  - Cr FEC Asset R24 000

  - Dr Bank (R20k + R22k – R24k) or ($100k x (R9.98 – R9.80)) R18 000
  - Cr FEC Asset R18 000

Hedge type 2: cash flow hedge

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- **Cash flow hedge** hedges the <u>risk of changes in the cash flows</u> of:
  - recognised financial instruments (e.g. interest rate risk on variable interest rate loans) or
  - firm commitments/highly probable forecast transactions (price risk or foreign exchange risk)
  - net investments in a foreign operation (foreign exchange risk)

- Examples of hedging instrument used to hedge designated hedged item's risk:
  - Interest rate swap (swap variable rate for fixed interest rate)
  - Foreign currency FEC (on foreign firm commitment or foreign highly probable forecast transactions) to hedge foreign exchange risk
  - Commodity FEC (on foreign firm commitment or highly probable forecast transaction) to hedge price risk
  - Foreign long-term loan obtained (to hedge forex risk on net investment in foreign operation)

Hedge type 2: cash flow hedge (2)

- Changes in the cash flows of CASH FLOW hedges **(hedging instrument)**, are **accounted for in other comprehensive income (OCI)** and the hedging instrument (e.g. interest rate swap or forex FEC or commodity FEC) as an asset or liability in the statement of financial position – only the effective portion! The *ineffective* portion is recognised in profit or loss

- The hedging gain/loss recognised in other comprehensive income shall be **reclassified ('recycled') to profit or loss** when the hedged item is recognised in profit or loss *or* when the hedging relationship ends

Hedge type 2: cash flow hedge (3)

- Hedge accounting is **discontinued** if:
  - The hedging instrument expires or is sold or terminated;
  - The hedge no longer meets the requirements of hedge accounting; or
  - The entity revokes the designation
  - The forecast transaction (which is the hedged item) is no longer highly probable

Example: cash flow hedge of HPFT

- Example 2: Foreign highly probable forecast transaction (HPFT) hedged by **cash flow hedge**

- Company A (Pty) Ltd places a cancellable order for inventory on 20 January 2020 to the value of $100 000. The inventory is delivered on 29 February 2020. Company A's reporting date is 31 March 2020, at which date the foreign creditor is still unsettled and 40% of the inventory acquired in this transaction had been sold. By 30 April 2020 the remainder of the inventory had been sold. The foreign creditor is settled at 30 April 2020. Company A (Pty) Ltd took out a hedge (foreign exchange FEC) on 20 January 2020 to cover the payment of the creditor on 30 April 2020 at $1 = R9.80. Company A (Pty) Ltd complies with **all** hedging criteria, except that hedge effectiveness must be assessed on an ongoing basis.
- The spot rates and FEC rates for similar FEC's than Company A (Pty) Ltd's FEC, are as follows:

	Spot rate	FEC rate
20 January 2020	$1 = R9.50	$1 = R9.80
28 February 2020	$1 = R9.75	$1 = R10.00
31 March 2020	$1 = R9.90	$1 = R10.22
30 April 2020	$1 = R9.98	$1 = R10.30

Example (continued)

- <u>Solution</u>
- 20 Jan 2020 – no journal entries as no transaction date and hedge fair value = 0
- <u>29 Feb 2020 (transaction date)</u>
- *Effectiveness assessment*
  - Gain on hedge: \$100 000 x (R10.00 – R9.80) = <u>R20 000</u>
  - Loss on transaction: \$100 000 x (R9.75 – R9.50) = R25 000 = **80%** = effective
- *Journal entries*

  - Dr FEC Asset R20 000
  - Cr Hedging gain **(OCI)** R20 000

  - Dr Inventory (\$100k x R9.75) R975 000
  - Cr Foreign creditor R975 000

Example (continued)

- 31 March 2020 (year-end)
- *Effectiveness assessment*
  - Gain on hedge: $100 000 x (R10.22 – R9.80) = R42 000
  - Loss on transaction: $100 000 x (R9.90 – R9.50) = R40 000 = **105%** = effective
- *Journal entries*
  - Dr Hedging gain (OCI) R8 000
  - Cr Cost of sales (R20k x 40%) R8 000

  - Dr Forex loss (P/L) (R40 000 – R25 000 before) R15 000
  - Cr Foreign creditor R15 000

  - Dr FEC Asset (R42 000 – R20 000 before) R22 000
  - Cr Hedging gain (P/L) R22 000

  - Dr Cost of sales (40% x R975 000) R390 000
  - Cr Inventory R390 000

Example (continued)

- 30 April 2020 (settlement date)
- *Effectiveness assessment*
  - Gain on hedge: $100 000 x (**R9.98** – R9.80) = R18 000
  - Loss on transaction: $100 000 x (R9.98 – R9.50) = R48 000 = **37.5%** = ineffective
- *Journal entries*

	Dr	Cr
Dr Forex loss (P/L) (R48 000 – R15 000 – R25 000)	R8 000	
Cr Foreign creditor		R8 000
Dr For. creditor (R975k + R15k + R8k) or ($100k x R9.98)	R998 000	
Cr Bank		R998 000
Dr Fair value loss (P/L) (R18 000 – R22 000 – R20 000)	R24 000	
Cr FEC Asset		R24 000
Dr Bank (R20k + R22k – R24k) or ($100k x (R9.98 – R9.80))	R18 000	
Cr FEC Asset		R18 000
Dr Hedging gain (OCI) (R20k x 60%)	R12 000	
Cr Cost of sales		R12 000
Dr Cost of sales (R975k x 60%)	R585 000	
Cr Inventory		R585 000

IFRS for SMEs

Section 22 *Equity and Liabilities*

Overview of main areas in S22

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- Scope
- Classification of an instrument as liability or equity
- Original issue of shares or other equity instruments
  - Sale of options, rights and warrants
- Capitalisation issues, bonus issues and share splits
- Convertible debt or similar compound financial instruments
- Treasury shares
- Distributions to owners
- Non-controlling interest and transactions in shares of a consolidated subsidiary

Scope

- Section 22 assists in classification of FI's as either **liabilities**, or **equity**
- Also, how to account for the issue of equity instruments to investors/owners
- Share-based payment dealt with in section 26 of IFRS for SMEs
  - Entity receives goods/services from its employees as consideration for its equity instruments (e.g. shares and share options)
  - Entity receives goods/services from vendors of goods services in consideration for its equity instruments
- **Specific EXCLUSIONS from the scope:**
  - Investments in subsidiaries, associates and joint ventures
  - Employers' rights and obligations under employee benefit plans
  - Contracts for contingent consideration (from acquirer's perspective)
  - FI's, contracts and obligations under share-based payment transactions (share buy-backs are within the scope of section 22)

Classification of FI’s as Equity or FL

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- Equity = A – L (i.e. E = residual interest, a balancing figure)
  - Includes investments by the owners of the entity
  - PLUS: additions to those investments earned through profitable operations and retained in the entity for use in the entity’s operations
  - MINUS: reductions to those investments as a result of unprofitable operations and distributions to owners
- Liability = **present obligation** of entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying future economic benefits
- Liability definition is stronger…

Summary: Equity vs FL

Equity versus FL

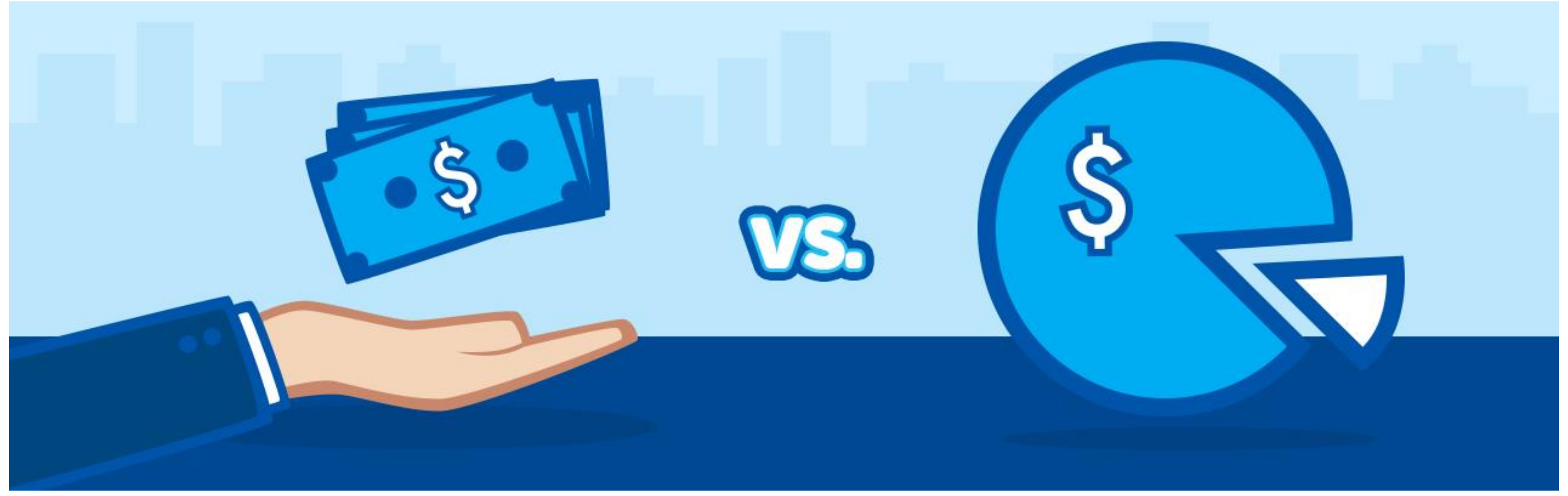
↓

Does the entity have an <u>unconditional</u> right to avoid settling in cash or another FA?

NO → **FL (fully/partially)**

YES → **How settled?**

- **Entity's own ordinary shares**
  - **Variable # or Variable R** → **FL**
  - **Fixed # and Fixed R** → **Equity**
- **Other** → **Equity**



Classification examples

- The entity issues 10 000 debentures that bear interest at 10% per annum (annually compounded and payable in cash). The debentures are <u>compulsorily</u> redeemable in cash at maturity date at par value plus 20% premium.
  - The debentures are initially classified as **FL's** in full

- The entity issues 10 000 preference shares that bear preference dividends at 8% per annum (annually compounded and payable in cash). The preference shares are <u>compulsorily</u> convertible into 2 000 ordinary shares of the entity at maturity date.
  - The preference shares are initially classified as **compound FI's**
    - (capital = equity; interest = FL)

Classification examples (2)

- The entity issues 5 000 preference shares that earn preference dividends at 10% per annum (compounded annually). The preference dividends are non-cumulative in nature, i.e. if not declared, they are forsaken. The preference shares are <u>compulsorily</u> convertible into 2 500 ordinary shares of the entity at maturity date.
  - The preference shares are initially classified as **equity** in full

- The entity issues 10 000 bonds that bear coupon interest of 10% per annum (compounded annually and payable in cash). The bonds are <u>compulsorily</u> convertible into a number of ordinary shares of the entity equalling the nominal value of the bonds plus a premium of 5% on nominal value.
  - The bonds are initially classified as **FL's** in full

Classification examples (3)

- The entity issues 5 000 bonds that bear interest at 12% per annum (annually compounded and payable in cash). The bonds are convertible at the choice of the holder into 3 000 ordinary shares of the entity at maturity date. If such conversion is not exercised, the bonds are redeemable in cash at par value.
  - The bonds are initially classified as **compound FI's** (interest = FL, capital = FL, conversion option = equity)

- The entity issues preference shares that earn preference dividends at 10% per annum (compounded annually and payable in cash). Preference dividends are non-cumulative in nature. The preference shares are convertible at the choice of the issuer (i.e. the entity) into 3 000 ordinary shares of the entity at maturity date. If such conversion is not exercised, the preference shares are redeemable in cash at par value.
  - The preference shares are initially classified as **equity** in full

Compound financial instruments

- The **ISSUER** of a compound financial instrument shall, at initial recognition, recognise separately the FL and equity components of the financial instrument

- The **proceeds** of the issue shall be allocated between FL and equity components

- Steps to follow with compound financial instruments:
  - 1. Value the FL component **first** (= PV of all cash flows that cannot be unconditionally avoided, discounted at a market rate for a similar instrument without a conversion option, think of interest, dividends and capital!)
  - 2. Allocate the PV (per step 1) to FL and the remainder of the proceeds to equity component (as a balancing figure)
  - 3. Use the effective interest method to subsequently account for the FL
  - 4. Equity is not re-measured

Example: compound FI's

- On 1/1/2020, the entity issues 500 convertible bonds. The bonds are issued at par with a face value of R100 per bond and are for a 5-year term, with no transaction costs. The total proceeds from the issue are R50 000. Interest is payable annually in arrears at a nominal interest rate of 4%, pre-tax. Each bond is convertible, at the holder's discretion, into 25 ordinary shares of the issuer at any time to maturity. At the time the bonds are issued, the market interest rate for similar debt that does not have a conversion option, is 6% per annum.

- **Step 1:** Value the FL component first. The settlement of the interest payments as well as capital of the bonds cannot be <u>unconditionally</u> avoided and are FL's.
  FV = R50 000 (redemption amount)
  Pmt = R2 000 (4% x R50 000) (interest payable annually)
  I/Yr = 6% (use MARKET-RELATED rate as debt is being VALUED)
  N = 5
  P/Yr = 1
  Thus PV = R45 788 (rounded)

Example (continued)

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- **Step 2:** Allocate the proceeds between FL and equity
  - 1/1/2020
  - Dr Bank R50 000
  - Cr Financial liability (bonds) R45 788
  - Cr Equity (conversion option) R4 212
- **Step 3:** Account for effective interest on FL in subsequent periods
  - 31/12/2020
  - Dr Interest expense (P/L) R2 747
  - Cr Bank (R50 000 x 4%) R2 000
  - Cr Financial liability (bonds) R747 (balancing figure)

Q&A

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Please use the chat sidebar to the right of the video / presentation on the screen to ask your questions.

If you would like to e-mail a question, please use:

technicalquestions@accountingacademy.co.za

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Thank you for your participation

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