IFRS news

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Valuation: Key considerations for impairment tests

Against the backdrop of volatile stock markets and falling commodity prices, Attul Karir from our Valuation practice shares key considerations when reviewing the suitability of cash flows and the discount rate used in impairment testing under IAS 36.

ESMA (the European Securities and Markets Authority) has identified the following enforcement priorities that they, together with national bodies in Europe, will examine within listed companies' 2015 financial statements:

- the impact of financial market conditions on financial statements, particularly the current interest rate environment, country and FX risk, and volatility in the price of commodities,
- fair value measurement and related disclosures, and
- statement of cash flows and related disclosures.

Sector-specific areas of focus

Sector-specific factors and regulatory scrutiny from industry bodies can affect valuations. For instance, commodity prices will affect projections and their perceived riskiness in different ways depending on whether commodities are an input or an output.

What does this mean for financial reporting valuations?

Impairment triggers

Have all impairment triggers (both, internal and external) been duly considered, paying particular attention to the interest rate environment, commodity prices, country risk and foreign exchange?

Are key assumptions consistent with information that is observable in the external market?

Regulators have observed that discount and terminal growth rates are often incorrectly identified as the only key assumptions. Have the key assumptions on which the cash flow projections are based been properly disclosed?

Fair value measurement and related disclosures

Valuation techniques need to meet the requirements of IFRS 13 *Fair value measurement*, that is, the use of observable inputs should be maximised and where available, issuers should use quoted prices in an active market without adjustment.

Where a third party determines fair value, this should be disclosed.

IFRS 7 *Financial Instruments: Disclosure* requires that issuers provide a description of the valuation techniques and inputs used. The following disclosures are not always adequately made: any changes in valuation techniques and reasons for those changes, levels of fair value hierarchy,

sensitivity to changes in unobservable outputs and whether current use differs from highest and best use.

What are the key considerations when reviewing the suitability of cash flows and the discount rate used in impairment testing under IAS 36 Impairment of assets?

Cash flows

- Overly optimistic:
  - How has the business been performing?
  - Are cash flows adjusted for current market conditions?
  - Are the projections consistent with segmental disclosures in the financial statements?
  - Have growth rate assumptions been compared to peers and analyst reports?
  - First 5 years versus terminal growth rate, both types of growth rate require support.
- Impact of commodity prices:
  - Low prices have persisted and need to be reflected in asset valuations for businesses.
  - Commodities can be both inputs and outputs in a business – projections should reflect expected commodity prices.
- Allocation of overheads:
  - General administrative (SG&A) costs should be allocated to cash generating units (CGUs).
- Future enhancements:
  - Value in use must be based on maintenance, not enhancement of capital expenditure.

Discount rate

- Current interest rate environment: in Europe the low or even negative interest rates for certain benchmarks (that is, for some government and high quality corporate bonds) need to be carefully reflected in the inputs used for the WACC.
- Currency versus country risk - these are not the same thing:
  - Currency risk relates to capturing inflation differentials if using a developed world risk free rate for projections denominated in local currency.
  - Country risk relates to the economic environment of the country in a geo-political context. A separate country risk premium is only usually relevant when cash flow projections are prepared in a different currency. If a local cost of capital has been estimated, it will already include a country risk premium in the local risk free rate.
- Target capital structure:
  - The entity specific debt to equity ratio should not be used to arrive at gearing for the weighted average cost of capital. It should instead be based on the industry average or target gearing.
- Using a single discount rate for multiple CGUs (or multiple regions):
  - Use of a single discount rate can be difficult to support as it implies that the cash flow projections for each CGU are equally risky.

Next steps

Impairment tests continue to be a hot topic for stakeholders ranging from regulators and investors right through to the media. Based on our findings we think that more work will need to be done by companies. Further guidance is available on Inform: Valuation guidance paper and In Depth: Expanding on the top 5 tips for impairment testing.

Current IC rejections

Derek Carmichael and Tatiana Geykhman from Accounting Consulting Services examine some of the issues the IC rejected at their March meeting.

IFRS 9 Financial Instruments – Determining hedge effectiveness for net investment hedges

The IC observed that when accounting for net investment hedges, an entity should apply the "lower of" test in determining the effective portion of the gains or losses arising from the hedging instrument. This application avoids the recycling of exchange differences arising from the hedged item that have been recognised in other comprehensive income before the disposal of the foreign operation, which is aligned with the requirements of IAS 21 *The effects of changes in foreign exchange rates*.

IAS 16 Property, plant and equipment and IAS 38 Intangible assets – Variable payments for asset purchases

The IC received a request to address the accounting for variable payments to be made for the purchase of an item of property, plant and equipment or an intangible asset that is not part of a business combination.

The IC was unable to reach a consensus on recognition and measurement of such variable payments. The IC observed that the IFRSs do not include requirements that are sufficiently clear and concluded that the Board should address accounting for variable payments comprehensively.

IAS 32 Financial Instruments: Presentation

Classification of liability for a prepaid card in the issuer's financial statements

The IC discussed the accounting for a prepaid card with the following features:

- No expiry date, no back-end fees,
- Non-refundable, non-redeemable and non-exchangeable for cash,
- Redeemable only for goods or services to a specific monetary amount,
- Redeemable only at specified third-party merchants.

The IC observed that the entity's liability for the prepaid card meets the definition of a financial liability. Consequently, the requirements in IFRS 9 *Financial instruments* should be applied to account for that financial liability. The IC also noted that customer loyalty programmes were outside the scope of its discussion on this issue.

Offsetting and cash-pooling arrangements

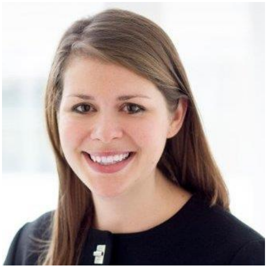
The IC discussed whether a particular cash-pooling arrangement would meet the requirements for offsetting in accordance with IAS 32 – specifically whether the regular physical transfers of balances into a netting account would be sufficient to demonstrate that an intention to settle the entire period-end account balances on a net basis.

The IC observed that net presentation more appropriately reflects the amounts and timings of the expected future cash flows only when there is an intention to exercise a legally enforceable right to offset. In making this assessment, an entity considers normal business practices, the requirements of the financial markets and other circumstances if appropriate.

The IC notes that in the specific example, it would not be appropriate for the group to present these balances net, as the group did not expect to settle its subsidiaries' period-end balances on a net basis.

However, the IC also observed that in other cash-pooling arrangements, a group's expectations might be different. Consequently, the determination of what constitutes an intention to settle on a net basis would depend on the individual facts and circumstances of each case.

The PwC leases lab



Professor Lee Singh presents the conclusions of his first experiment in the Pharmaceutical Industry with the help of his assistant Ruth Preedy.

Hypothesis

IFRS 16 will have a significant impact on the Pharma industry.

Testing and analysis

Pharma companies typically lease buildings, company cars and computers. Many of these arrangements are currently accounted for as operating leases. Under the new standard, almost all leases will be moved onto the balance sheet.

Medical device companies often supply equipment to hospitals and can be a lessor if the arrangement meets the definition of a lease. However, the definition and measurement of leases has changed under IFRS 16 and therefore the new standard will have consequences for both the lessor and lessee. The terms and conditions vary and can make assessing whether a lease exists complicated. Here are some of the terms that will need to be carefully considered in determining whether there is a lease:

- Equipment can be bespoke, made specifically for the customer.
- The equipment can be leased, with the supplier also providing consumables for use with the equipment.
- Payment structures vary. In some cases the equipment is free but the consumables are chargeable.
- There can be minimum order requirements for the consumables.
- Consumables can sometimes be substituted for other company products.

Where there has been a lease under IAS 17, the new standard has not changed lessor accounting significantly.

Conclusion

IFRS 16 will impact Pharma companies as both a lessor and lessee.

Practical application

The Pharma industry will need to do a thorough review of their systems. These need to be able to identify and track all contracts which meet the definition of a lease. They will also need to be able to identify any low value or short term leases as these qualify for an exemption.

Medical device companies may have additional considerations depending on the terms and conditions of their equipment leases.

More of the Professor's analysis of the impact of IFRS 16 Leases on the Pharma industry can be seen in our Spotlight.

Have you seen the latest PwC IFRS blogs

Gary Berchowitz wonders about online gaming in the context of the new revenue standard

Brian Peters sheds light into the latest trends in pension accounting

Cannon Street Press

Applying IFRS 9 Financial instruments with IFRS 4 Insurance contracts

In December 2015, the IASB issued an Exposure Draft to amend IFRS 4 Insurance Contracts to give entities whose business model is to predominantly issue insurance contracts the option to defer the effective date of IFRS 9 until 2021 (the temporary exemption). Alternatively, an entity could implement IFRS 9 but opt to remove from profit or loss some of the accounting mismatches and temporary volatility that could occur before the new insurance contracts standard is implemented (the overlay approach).

At the March meeting, the IASB tentatively decided to confirm the ED proposals with regards to the following:

- An optional temporary exemption from applying IFRS 9 will be provided for qualifying entities.
- The eligibility for the temporary exemption should be determined at the reporting entity level only.
- There should be a fixed expiry date.
- An overlay approach will be provided on an optional basis.

The remaining technical issues, including the qualifying criteria for the temporary exemption will be discussed at future meetings. The amendments are expected in Q3 2016.

Definition of a business

The IASB discussed the proposed amendments to IFRS 3 *Business Combinations*, which would clarify how to apply the definition of a business and would result in largely the same requirements as the FASB proposed amendments. The Board tentatively decided to issue an Exposure Draft, which is expected in Q3.

Goodwill and Impairment

The IASB discussed the following areas from its goodwill and impairment project:

- A possible modification to the impairment test to address user's concerns about late recognition of impairment losses and overstatement of goodwill,
- Improving the disclosure requirements for goodwill and impairment, and
- A possible improvement to the definition and guidance for customer relationships acquired in a business combination.

No decisions were made. The Board will continue its discussions at future meetings, including consideration of quantitative information about the amounts and trends of reported goodwill, impairment and intangible assets over recent years. The IASB also expects to discuss this project with the FASB again during the second quarter of 2016

Agenda Consultation

The Board discussed the feedback received in response to the 2015 agenda consultation and the 2015 trustee's review of structure and effectiveness. No decisions were made. The IASB will discuss the following at future meetings:

- The balance of the Board's activities and the prioritisation criteria that should be applied to individual projects,
- The comments received on individual projects and what effect those comments should have, and
- A draft work plan of the Board's activities.

IFRIC Rejections in short - IAS 17

Fernando Chiqueto of Accounting Consulting Services examines the practical implications of IC rejections related to IAS 17.

Looking for an answer? Maybe it was already addressed by the experts.

The Interpretations Committee (IC) regularly considers anywhere up to 20 issues at its periodic meetings. A very small percentage of the issues discussed result in an interpretation. Many issues are rejected; some go on to become an improvement or a narrow scope amendment. The issues that are not taken on to the agenda end up as "IFRIC rejections", known in the accounting trade as "not an IFRIC" or NIFRICs. The NIFRICs are codified (since 2002) and included in the "green book" of standards published by the IASB although they technically have no standing in the authoritative literature. This series covers what you need to know about issues that have been "rejected" by the IC. We go standard by standard and continue with IAS 17 as per below.

In January, the IASB issued the new leasing standard, IFRS 16. Nevertheless, the guidance in IAS 17 remains applicable for almost three years, making this an opportune moment to review how the IC addressed the questions raised on IAS 17.

Finance subleases of finance leases (June 2005)

The IC considered whether IAS 17 needed interpretation for situations when assets obtained under finance leases are in turn leased immediately by intermediaries. There was a view that intermediaries could treat the assets as inventory when acquired from the manufacturer followed by a sale to end users.

The IC noted that this issue was covered by both IAS 17's guidance for finance leases and the derecognition requirements of IAS 39. The IC did not agree with the suggestion to treat the assets as inventory.

Under IFRS 16, the head lease and the sublease are accounted for in accordance with both lessee and lessor accounting respectively. Finance lease liabilities are subject to IFRS 9's derecognition guidance.

Recognition of operating lease incentives under SIC-15 (August 2005)

The IC was asked to consider the appropriate period over which an incentive for an operating lease should be recognised when the lease contains a clause that requires rents to be repriced to market rates.

The IC noted that SIC-15 *Operating Leases - Incentives* requires a lessee to recognise the incentives as a reduction of rental expense over the lease term. The IC thought the wording was clear and did not accept an argument that the lease expense of a lessee after an operating lease repriced to market ought to be comparable with the lease expense of an entity entering into a new lease at the same time at market rates. Nor did the IC believe that the repricing would be representative of a change in the time pattern.

Under IFRS 16, any lease incentive is recognised as a reduction of the right-of-use asset.

Time pattern of user's benefit from an operating lease (November 2005)

The IC considered the income and expense recognition profile of an operating lease in which the annual payments rise by a fixed annual percentage over the life of the lease. The IC was asked whether it would be acceptable to recognise such increases in each accounting period when they are intended to compensate for expected annual inflation over the lease period.

The IC noted that the accounting under IAS 17 for operating leases does not incorporate adjustments to reflect the time value of money. Rather, IAS 17 requires a straight-line pattern of recognition of income or expense from an operating lease, unless another systematic basis is more representative of the time pattern of the user's benefit. The IC noted that recognising income or expense from annual fixed inflators as they arise would not be

consistent with the time pattern of the user's benefit.
Under IFRS 16, fixed payments are one of the components of the lease liability.

Leases of land that do not transfer title to the lessee (December 2005)

The IC was asked whether long leases of land would represent a situation when a lease of land would not "normally" be classified as an operating lease. IAS 17.14 stated that if title is not expected to pass to the lessee by the end of the lease term, then the lessee normally does not receive substantially all of the risks and rewards, in which case the lease will be an operating lease.

The word "normally" implies that a long lease of land could be treated as a finance lease, since the time value of money would reduce the residual value to an immaterial amount. However, the IC noted that one example affected by the word "normally" is a lease of land in which the lessor agrees to pay the lessee the fair value of the property at the end of the lease period. In such circumstances, risks and rewards associated with the land would have been transferred to the lessee despite there being no transfer of title.

The IC noted that a lease of land is classified as an operating lease unless title is expected to pass to the lessee or significant risks and rewards associated with the land pass to the lessee. Paragraph IAS 17.14 was removed by Improvements to IFRSs (issued April 2009).

Contingent rent (May 2006)

The IC considered whether an estimate of contingent rentals payable or receivable under an operating lease should be included in the total lease payments or lease income to be recognised on a straight-line basis over the lease term.

The IC noted that current practice is to exclude contingent rentals from the amount to be recognised on a straight-line basis over the lease term. The issue was not added to the agenda.

Under IFRS 16, the lease liability comprises only those variable lease payments that depend on an index or a rate (for example, payments linked to a consumer price index, benchmark interest rates or payments that vary to reflect changes in market rental rates). Variable lease payments linked to future performance of use of the underlying asset are excluded from the measurement of lease liabilities.

Sale and leasebacks with repurchase agreements (March 2007)

The IC considered how sale and leaseback transactions should be accounted for when the seller or lessee retains control of the leased asset through a repurchase agreement or option.

The IC noted that IAS 17, rather than IAS 18, provides the more specific guidance with respect to sale and leaseback transactions. Consequently, it is not necessary to apply the requirements of IAS 18 to sale and leaseback transactions in the scope of IAS 17.

Under IFRS 16, an entity uses IFRS 15's guidance on performance obligation in order to determine whether the transfer of an asset is accounted for as a sale. However, if the seller-lessee has a substantive repurchase option, then no sale has occurred.

Time pattern of the user's benefit (September 2008)

The request asked for guidance on what alternatives to straight-line recognition of lease expense might be appropriate.

The IC noted that IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* require an entity to recognise the use of productive assets based on a method that best reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. In contrast, IAS 17 refers to the time pattern of the user's benefit. Therefore, any alternative to the straight-line recognition should reflect the time pattern of the use of the leased asset.

Purchase of right to use land (September 2012)

The IC received a request to clarify whether the purchase of a right to use land should be accounted for as i) purchase of PP&E; ii) purchase of an intangible asset; or iii) lease of land. In the fact pattern submitted, the laws and regulations would not permit entities to own freehold title to land.

The IC identified characteristics of a lease in the fact pattern considered. The IC noted that a lease could be indefinite via extensions or renewals and, therefore, the existence of an indefinite period does not prevent the "right to use" from qualifying as a lease in accordance with IAS 17. The IC also noted that the lessee has the option to renew the right and that the useful life for depreciation purposes might include renewal periods. Judgement will need to be applied in making the assessment of the appropriate length of the depreciation period.

Summary of IAS 17 rejections

Topic	Summary conclusion
Finance subleases of finance leases (June 2005)	The IC agreed that IAS 17 was clear on the guidance for finance leases both for the intermediary in its capacity as lessee and a lessor and for the end user as a lessee. The derecognition requirements of IAS 39, as they apply to the finance lease liabilities of the intermediary, are also clear.
Recognition of operating lease incentives under SIC-15 (August 2005)	IC thought the wording in SIC-15 was clear and that the lessee is required to recognise the aggregate benefit of operating lease incentives as a reduction of rental expense over the lease term on a straight-line basis, unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset.
Time pattern of user's benefit from an operating lease (November 2005)	IAS 17 requires a straight line pattern of recognition of income or expense from an operating lease unless another systematic basis is more representative of the time pattern of the user's benefit. The IC noted that recognising income or expense from annual fixed inflators as they arise would not be consistent with the time pattern of the user's benefit.
Leases of land that do not transfer title to the lessee (December 2005)	A lease of land, irrespective of the lease term, is classified as an operating lease unless title is expected to pass to the lessee or significant risks and rewards associated with the land at the end of the lease term pass to the lessee.
Contingent rent (July 2006)	The IC noted that they did not expect contingent rental payments being included in the amount to be recognised on a straight-line basis over the lease term for operating leases.
Sale and leasebacks with repurchase agreements (March 2007)	The IC tentatively agreed that IAS 17 rather than IAS 18 provides more specific guidance with respect to sale and leaseback transactions for transactions that convey a right to use an asset. Otherwise IAS 17 is not applied.
Time pattern of the user's benefit (September 2008)	The IC felt that IAS 17 is clear that any departure from the straight-line recognition of lease expense under an operating lease must reflect the time pattern of the use of the leased asset, rather than the lessor's costs or benefit. The IC did not expect significant diversity of practice to arise.
Purchase of right to use land (September 2012)	The IC noted that the existence of an indefinite period does not prevent the "right to use" from qualifying as a lease in accordance with IAS 17.
Meaning of "incremental costs" (March 2014)	The IC was asked whether salary costs of permanent staff involved in negotiating and arranging new leases qualify as "incremental costs" and should therefore be included as initial direct costs in the initial measurement of the finance lease receivable. The IC noted that such internal fixed costs do not qualify as "incremental cost". Only those costs that would not have incurred if the entity had not negotiated and arranged a lease should be included in the initial measurement of the finance lease receivable.

Cryptic IFRS word seek

Give your brain a workout and keep it buzzing for your next accounting term! All the terms described on the right have something to do with IFRS. See how many you can find in the word grid! However, it is not as easy as you think...some of the words in the grid have nothing to do with accounting! In order to keep it simple all the words are forwards and there are no diagonal ones.

E	I	E	V	S	T	A	J	Y	R	V	U	A	I	K	V	R	V	C	U
R	H	E	I	H	R	R	S	U	G	A	R	Y	R	O	Y	A	L	T	Y
T	E	A	V	I	R	T	U	A	L	L	Y	C	E	R	T	A	I	N	S
T	N	C	I	G	E	U	F	L	E	E	I	A	M	I	I	P	N	O	D
X	L	A	R	H	A	I	F	S	A	S	E	S	O	O	A	M	S	T	A
A	E	P	O	L	I	C	I	E	S	S	L	H	T	M	R	I	U	E	E
G	Y	U	S	Y	U	L	C	R	E	I	D	A	E	I	A	M	L	S	Y
N	R	T	U	P	A	T	I	W	I	N	S	L	A	G	O	M	I	O	G
S	E	O	P	R	A	T	E	R	E	G	U	L	A	T	I	O	N	M	C
Y	G	P	R	O	B	A	N	E	L	R	B	I	S	I	M	O	N	G	A
D	A	T	A	B	R	S	T	A	L	E	S	O	S	O	P	R	A	N	Q
S	T	I	S	A	U	C	L	L	I	T	I	B	O	S	R	O	A	Q	W
C	T	O	O	B	T	O	Y	I	E	L	D	R	C	C	A	T	M	W	E
V	A	N	T	L	E	T	L	O	W	E	I	A	I	U	C	H	O	E	R
E	S	H	T	E	R	R	O	R	I	U	A	I	A	S	T	I	R	R	T
X	G	O	O	L	E	O	W	A	T	E	R	K	T	I	I	S	T	T	Z
B	O	W	A	F	S	Y	E	I	R	U	Y	E	E	F	C	I	I	Y	D
H	L	L	E	I	E	A	R	A	C	E	R	T	S	R	A	L	S	O	J
N	F	O	T	Q	A	L	O	O	K	S	R	S	D	S	B	F	A	R	T
A	A	N	W	X	R	T	U	G	O	O	D	W	I	L	L	U	T	O	N
E	X	G	U	Z	C	Y	Y	O	P	E	R	A	L	I	E	N	I	E	T
S	V	U	W	Y	H	A	R	V	E	S	T	M	U	D	I	I	O	M	G
T	I	W	A	U	O	K	B	E	R	N	E	S	T	O	I	S	N	U	W
S	C	O	S	T	A	U	G	R	O	U	P	E	E	U	Y	N	Y	E	N
I	U	U	S	L	O	W	U	N	O	B	E	L	D	I	Y	T	S	I	B
I	A	H	E	L	P	M	E	M	A	N	U	A	L	O	F	I	F	R	S
P	R	E	T	R	O	S	P	E	C	T	I	V	E	I	Q	T	U	L	L
A	E	V	A	S	B	G	S	N	L	I	V	E	R	P	O	O	L	A	R
D	A	C	I	N	V	E	S	T	I	N	G	R	E	E	C	E	L	Y	V
Z	D	A	D	B	A	N	T	D	C	N	S	G	N	G	E	S	H	X	V

Horizontal:

Probability criterion (9,7)

A lot of boilerplate language

Until the bitter end (IAS 39)

Temporary topic (4, 10)

An APM

Return

Adjust for this retrospectively if material

Not until the bitter end (IAS 39)

Inherent profitability measure

Is it an asset?

Detachment of produce (IAS 41)

Charge

Accounting family

With hindsight

Cashflows for future profits

Vertical:

Probability criterion (7,8)

Likelihood of being exercised (12,5)

Probability criterion

Topic of the month (... accounting)

Profit before unfortunate debits

Hiding the tree in the wood of words

I might sell? (3,6)

Accounting kid

Accounting companion

Can't be done

Piecemeal consumption

Definitely not an asset

Shareholders' reduced profit share

Repetitive counterparty

Accounting debate club

Basis for future profits

The solution will be provided in IFRS News – May 2016. Impatient puzzlers can request the solution from the editor.

The bit at the back...

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