IFRS news

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IFRS 15 – Time is running out

Regulators are requesting transparency on the impact of the implementation on IFRS 15. Andrea Allocco explains the regulators' focus and why now is the time to start doing some work.

Companies are facing the adoption of several major new accounting standards in the next few years. For many it will be the most significant change in accounting since the adoption of IFRS.

What is required?

A company is required to disclose the impact of adopting new accounting standards that are issued but not yet effective. This has historically been achieved through disclosure that the company *'is currently assessing the impact of adopting IFRS X'*. Regulators no longer consider this disclosure to be enough.

ESMA

ESMA recently published a public statement urging reporters to provide relevant and transparent information about the expected impact of IFRS 15. This was more than the conventional request for best practice disclosure. ESMA is specific about the disclosures including guidance for both 2016 and 2017 interims. There is also an emphasis that disclosures should be entity specific. The disclosures for 2017 year-ends should be quantitative. This seems reasonable given entities will have adopted the new standard by the time they report but this is still a change from the past.

EITF

This message was echoed at a recent Emerging Issues Task Force (EITF) meeting in the US. The EITF assists the US regulator, the FASB, to resolve financial accounting issues. The SEC Observer at the meeting announced that the SEC expects registrants to provide disclosure on the potential impact and the status of their adoption of the new revenue, leasing, and credit loss standards. The SEC Observer was focused on the upcoming year-end filings and was clear that this applied to foreign private issuers as well.

What now?

The regulators are calling for disclosure, but, more importantly, it can be taken as a warning that companies need to start working on implementation of the new standards now. IFRS 15, IFRS 16 and IFRS 9 are expected to have a significant impact on companies and can be complex to apply. For more information about some of the complexities in the new standards, our new regular IFRS 15 column starts in the next edition.

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Beware of Value in Use

Mary Dolson talks through the common pitfalls of using value in use (VIU) in an impairment review.

Impairment of non-financial assets under IAS 36 remains a hot topic with regulators and users. Six years past the start of the financial crisis, slow or no growth and low commodity prices continue to challenge companies. These issues and new 'unknowns' such as Brexit are working their way through into impairment testing.

Regulators in the major capital markets that use IFRS now have a fair amount of enforcement experience. There have been a number of recent enforcement actions from regulators focusing on impairment under IAS 36 and VIU has emerged as a theme.

Recoverable amounts under IAS 36, both fair value and VIU can be calculated using a cash flow model. There is a perception that VIU is 'user friendly'. Our recent experience with regulators does not support this view. VIU is a cash flow model that exists only in IAS 36 and has a number of prescriptive rules.

Regulators are increasing their scrutiny of companies that assert application of VIU. Why? Because a regulator may be able to deduce from disclosures, or establish with a few carefully chosen questions, that the company is not following all of the VIU 'guidance'. An approximation of VIU was less worrying during times of strong economic growth, however, regulators are clearly more concerned in the current environment. You need to ensure that if you assert compliance with VIU you are prepared to explain how you have complied with the detailed guidance.

An aspect of VIU that has received increasing attention is the requirement to model 'probable' cash flows. An asset in development, such as an oilfield in development or an acquired IPRD asset may not have 'probable' revenues in the five-year forecast window.

Some question if it is possible to use VIU to test these types of assets. Some regulators have asserted 'no probable cash flows, no VIU'. A company that wants to use VIU will need to do significantly more complex modelling to overcome the absence of probable future cash flows. The cash flow model will need multiple scenarios, each probability-weighted. Risk needs to be included in both cash flows and discount rates so be prepared to use a substantially higher discount rate.

Pre-tax rates and pre-tax cash flows are an obvious and understandable area where it is difficult to comply with IAS 36. There are no observable pre-tax rates available. Modelling out the cash tax flows is very challenging; both parts of that equation are so difficult that it is rarely seen in practice.

VIU doesn't just say 'pre-tax' and 'probable'. The VIU section of the standard has guidance on determining the cash flows to model. Regulators are reading this guidance and challenging the assumptions underpinning VIU cash flows.

We have 'translated' quotes from IAS 36 as follows:

Quote	Translation into plain English
33 (a) base cash flow projections on **reasonable and supportable assumptions** that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. **Greater weight shall be given to external evidence.**	Make good faith estimates. Do not ignore market data.
33 (b) base cash flow projections on the **most recent financial budgets/forecasts approved by management**, but shall **exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance.** Projections based on these budgets/forecasts shall cover **a maximum period of five years**, unless a longer period can be justified.	Do not create a special forecast for your impairment testing. Test the asset or business you own, not the business or asset you hope to make it into. Be prepared to defend your terminal value or specific forecasts beyond the five year period (more below on this).
33 (c) estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or **declining growth rate for subsequent years**, unless an increasing rate can be justified. This growth rate **shall not exceed the long-term average growth rate** for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified	Avoid the classic errors that create the valuation hockey stick in cash flow models: • Model incorporates growth that implies a level of consumption beyond the population of the planet • Growth is greater than that of the competition which is not sustainable over more than the short term. Higher growth or premium cash flows attract more competition.

VIU may be a 'false friend'; difficult to comply with, voluminous disclosures mandated by the standard and easily challenged by regulators.

If a company is using VIU, they should ensure that all of the VIU rules are followed and all VIU disclosures are made.

Have you seen the latest PwC IFRS blogs

Sandra Thomson IFRS 9 Myth Busters

Dave Walters The Emperor Augustus – The Accountant's Accountant

Cannon Street Press

Disclosure initiative

The Board discussed comments received on the ED and tentatively decided to:

- add additional clarity on the intended audience, objectives and definition of materiality in the Practice Statement.
- revise the guidance to include 'meeting the maximum amount of common information needs of primary users'.
- explain that entities should consider both quantitative and qualitative factors for material items.
- state that a single materiality assessment should be applied to all information.
- describe how an entity should use a materiality assessment to decide how much detail to include.
- emphasise that the Practice Statement does not prohibit providing information to meet local regulatory requirements unless such information obscures material IFRS information.
- clarify that an entity should consider the same factors for materiality in its interim and annual financial statements.
- clarify additional considerations for interim report.
- specify that public availability of information does not affect the materiality assessment or the obligation to disclose material information.

Conceptual Framework

The Board continued to discuss the conceptual framework and tentatively decided:

- that an executory contract establishes an independent right and an obligation to exchange economic resources.
- to clarify that the unit of account is selected for an asset or a liability when considering how recognition and measurement will apply. The unit of account may differ for recognition and measurement.
- the Framework should acknowledge that prudence does not imply a need for asymmetry.
- to confirm that the definition of materiality proposed in the ED will not be updated for the amendments discussed in the Principles of Disclosure project.

Clarifications to IFRS 8 Operating Segments arising from the Post implementation Review

The Board tentatively decided to amend IFRS 8 to require an entity to explain how and why the reportable segments in the financial statements differ from those included in other communications published with the financial statements.

IFRS Implementation issues

The Board approved the IFRIC Interpretation, *Foreign Currency Transactions and Advance Consideration* and expects to issue the Interpretation before the end of 2016.
The Board tentatively decided to:

- propose amendments to IAS 28 as part of the next cycle of annual improvements (2015–2017) to clarify that an entity applies both IFRS 9 and IAS 28 to long-term interests.
- amend IAS 16 to prohibit the deduction of the proceeds from testing from the cost of an item of PPE.

Financial Instruments with Characteristics of Equity

The Board tentatively decided that, for the gamma approach, economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a claim as either a liability or equity. Classification would be based on the substantive rights and obligations established by a contract, including obligations that are established indirectly through the terms of the contract.

The leases lab

The definition of a lease is a complex area in IFRS 16. Professor Lee Singh explores predetermined use contracts with the help of his assistant Nitassha Somai.

Hypothesis

Contracts for the use of an asset in a predetermined manner will not meet the definition of a lease and result in fewer leases recognised on the balance sheet.

Testing and analysis

Lessees might enter into contracts that predetermine how and for what purpose an asset is used. A common feature of these contracts is that the supplier either operates the asset or there is upfront agreement between the parties on how the asset will be used. Examples of these contracts include:

- Owner driver contracts;
- Vessel charter contracts;
- Solar farm arrangements or energy contracts;
- Specialised machinery; and
- Network service contracts entered into with communication companies.

IFRS 16 focuses on the concept of control and requires both a benefit (substantial economic benefits) and power element (right to direct the use) to be present for a contract to qualify as a lease.

Assessing the benefits can be relatively easy for such contracts. The frequently asked question is whether the lessee has the right to direct the use of the asset if the 'how' and 'for what purpose' is predetermined in the contract.

A lessee can demonstrate a right to direct the use of the asset in such predetermined cases if it either (a) operates the asset, without the supplier having the right to change those operating instructions; or (b) designs the asset in a way that determines how and for what purpose the asset will be used.

For example, an agriculture company might enter into an 'owner driver' contract to transport grain from Bloemfontein to Johannesburg using a specified highway. The truck needs extensive customisation to prevent co-mingling between three types of grains. The company engages an engineer to customise the truck. The transportation company will use its own drivers.

Neither company decides how and for what purpose the truck is used. Those decisions are predetermined in the contract. That is, the specific route to be taken is pre-programmed and the relevant decision-making rights about how and for what purpose the truck is used throughout the period of use are also predetermined.

However, the customer's involvement in the customisation of the truck has given it the right to direct the use of the truck as this is substantively no different to the agriculture company directly controlling those decisions. This contract would meet the definition of a lease as there is both a benefit and power element. If the agriculture company were not involved in the customisation of the truck, the contract would be accounted for as a service contract.

Conclusion

Existing pre-determined contracts might already provide the lessee with the right to direct the use of the asset and hence meet the definition of a lease today. Similar contracts will continue to meet the definition of a lease under the new standard and will be recognised on the balance sheet. This will also apply to similar contracts accounted for as operating leases today.

Practical application

Lessees will need to consider the significance of both predetermined and non-predetermined decisions and the impact on how and for what purpose the asset is used. This includes understanding which party makes those decisions. Predetermined decisions designed solely to protect the interests of the supplier are not substantive when performing the lease assessment.

See our video: The definition of a lease.

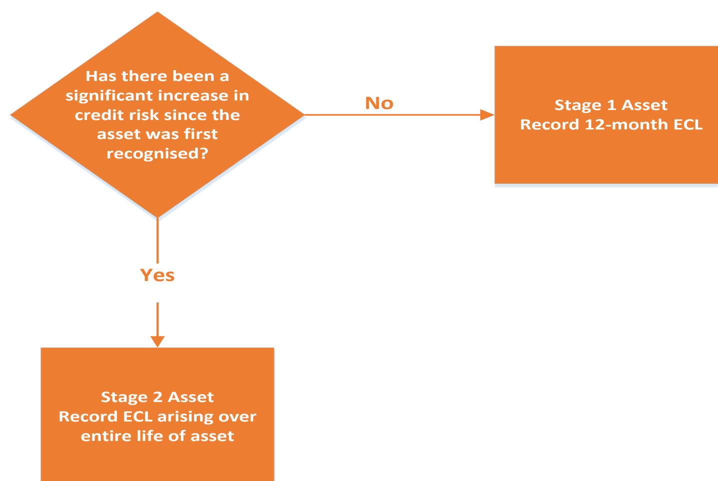
More from PwC on the commercial and practical impact of IFRS 16: The leases standard is changing. Are you ready?

Demystifying IFRS 9

Hannah King, PwC Financial Instruments specialist, explains how it's all relative for expected credit loss requirements under IFRS 9 until you fall off the cliff.

Credit risk management sits at the core of banking and IFRS 9's new expected credit loss (ECL) requirements go straight to the heart of this. This first column in our series looks at how to understand and apply IFRS 9's new impairment requirements for financial assets.

The fundamental question for determining ECL is whether there is a significant increase in credit risk since intial recognition of a financial asset. See the diagram below. The answer determines the size of the impairment loss allowance at the reporting date: it tells you whether the 'cliff effect' applies. No significant increase in credit risk since initial recognition and you have a 'stage 1' asset.
Only a 12-month ECL are recognised, being expected losses associated with the risk of default in the next 12 months. If there has been a significant increase in credit risk, the asset is in 'stage 2' and *lifetime* ECL are booked. Lifetime ECL estimates the expected losses associated with the risk of default over the whole life of the instrument.



This could be a significantly bigger number for any asset with a life greater than 12 months. A bigger ECL would reduce reported profits and asset carrying amounts, with possible negative implications for regulatory capital.

Assessing a significant increase in credit risk is a relative test

The assessment of significant increase in risk is a *relative* measure. Banks are required to compare credit risk at the reporting date with credit risk at the date of initial recognition of the asset. This can lead to some strange effects. For example, a bank makes two similar loans to the same customer at different times when the credit risk of the customer is different. The credit rating of each loan is the same at the reporting date. The relative increase in credit risk since initial recognition for each loan will differ. Thus, one of those loans may be in stage 1 and the other could be in stage 2.

Credit risk management in banks is usually focused on credit risk at a point in time, not changes in credit risk over time. A bank may seek to use an 'absolute' level of credit risk at the reporting date when assessing significant increases in credit risk. All loans that are assessed to be more risky than a certain threshold credit risk rating are treated as being in stage 2.

This approach has its attractions: it is simpler to operationalise and avoids the need to track the initial credit risk of each loan. However, it can only be used if it is consistent with the requirement to identify significant increases in credit risk on a relative basis. The bank would need to identify groups of loans whose credit risk on initial recognition falls within a narrow band regardless of their date of initial recognition. The bank will also need to demonstrate that increases in credit risk within this narrow band do not represent a significant increase in credit risk, but increases in credit risk beyond this narrow band do represent a significant increase in credit risk. This is likely to be challenging.

A change in the risk of default is the key driver for a significant increase in credit risk

It is the change in the risk of default, or the probability of default (PD), that is important when considering whether there has been a significant increase in credit risk. The amount of future expected losses is irrelevant.

For example, the risk of default of a fully collateralised mortgage could have significantly increased since initial recognition because the borrower has lost their job. The mortgage will be in stage 2, even though the ECL may be minimal, as the bank has sufficient collateral.

Changes in 12-month PDs may be a reasonable approximation of changes in lifetime PDs

Assessments of significant increase in credit risk are based on changes in the risk of default over the life of the asset. However, regulators often focus on 12-month PD (that is, the risk of default over the next 12 months). Banks may use changes in 12-month PDs provided they are a reasonable approximation of the changes in lifetime PDs.

Banks may already have regulatory 12-month PDs, but these will generally need adjusting to meet the requirements of IFRS 9.

Looking for more information? Seen PwC's videos – links in the box below.

What next?

Next month's column will cover more questions on significant increase in credit risk.

Want to find out more? Watch our short video:

Demystifying IFRS 9 Impairment: 2. Significant increase in credit risk

Our Financial Instruments specialists guide you through the perils and pitfalls of IFRS 9's Expected Credit Loss requirements.

Don't miss other videos in the series:

Demystifying IFRS 9 Impairment: playlist

IFRIC Rejections in short - IAS 26

Ernesto Mendez of Accounting Consulting Services examines the practical implications of IC rejections related to IAS 26.

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 26 as per below.

IAS 26, *Accounting and reporting by retirement benefit plans,* deals with accounting in the financial statements of retirement benefit plans themselves. The IC has rejected two matters related to IAS 26 over the last decade.

Conflict between scope and definitions of IAS 26 Accounting and Reporting by Retirement Benefit Plans (March 2004)

The IC received a request to clarify the scope of IAS 26. The scope of IAS 26 states: *"Some retirement benefit plans have sponsors other than employers; this Standard also applies to the financial statements of such plans."* However, the definition of retirement benefit plans in the standard is *"arrangements whereby an enterprise provides benefits for its employees on or after termination of service…"* The requester asked the IC to clarify if IAS 26 only applied to plans sponsored by employers or if it was broader. The IC agreed that the wording of IAS 26 could be improved, but noted that the intention of the Standard was clear and applied to plans with sponsors other than employers.

Valuation of plan assets (May 2010)

The IC received a request to clarify the interaction between IAS 26 and IAS 39 *'Financial Instruments: Recognition and Measurement.'* The IC observed that plan assets should be measured at fair value following IAS 26. The IC also noted that it is clear that changes in the fair value of plan assets should be presented and disclosed in accordance with IAS 26 in the statement of changes in net assets available for benefits.

The IC concluded that IFRSs are clear and that divergent interpretations are not expected in practice. Consequently, they rejected this issue.

Have you seen PwC's latest publications?

IFRS 16 Leases – Spotlight on the Chemicals Industry: *A summary of the significant impacts of the new leasing standard on Chemicals*

IFRS 16 Leases In Depth – Pharmaceutical supplement: *A detailed look at the implications of the new leasing standard on the Pharmaceutical and life sciences industry.*

Amendments on IFRS 4 – PwC In depth: *Detail on the recent amendments to IFRS 4 - relief for insurers regarding IFRS 9*

The bit at the back...

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