



IFRS news

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Impairment through the eyes of regulators

Ruth Preedy from Accounting Consulting Services analyses the 2014 ESMA enforcement decisions in relation to IAS 36.

The first half of 2015 has been marked by increased volatility in global markets. This economic environment could lead to revised budgets and forecasts with an expectation of lower cash flows from existing non-financial assets. With the amount of headroom diminishing, regulators have put impairment at the top of the agendas. So, what do they focus on? This article is based on a review of the 2014 ESMA enforcement decisions in relation to IAS 36.

There were three common themes coming out of the 2014 enforcement decisions:

- 1) Cash flows should be reasonable and supportable.
- 2) The discount rate used should be determined in accordance with the standard.
- 3) Disclosure requirements are often missed.

Cash flows should be reasonable and supportable

Assumptions in cash flow models must be reasonable and supportable. They should represent management's best estimate of the economic circumstances that will prevail over the remaining life of the asset

or cash-generating unit (CGU). Greater weight should be given to external evidence. It is important that any assumptions are consistent with other data.

Regulators will consider different data to understand if the assumptions disclosed in the financial statements are supportable. For example, regulators will perform cross-checks by considering information about what's happening in the market, the industry, and other areas of the financial statements and past performance.

Market Data

If a CGU is an investment which has a quoted price, a regulator will check if its fair value equals the share price multiplied by the quantity of shares. Where issuers have argued that their share price is not active because the shares do not trade daily, regulators have pushed back.

Value in use and fair value less cost of disposal may be different for a listed entity. However, a significant difference will require some strong justification for any regulator to accept it. Why does the market see something different to management? Maybe they have already priced the impairment into their view of the entity.



Financial Statements

The standard requires key assumptions to be disclosed. Regulators are known to execute enforcement decisions when the assumptions used in the impairment model are more optimistic than other information in the financial statements. A common example would be disclosing a significantly lower operating margin in the operating segment note compared to the one used in the value in use calculation.

Past performance

Another example for enforcement decisions is that future estimates were not supported by past performance. For example, current year cash flows are negative and far below budget, but management still predicts that there will be a turnaround in the following year.

The discount rate used should be determined in accordance with the standard

The discount rate used should reflect the specific risks of the asset which have not already been incorporated in the cash flows. Different CGUs might warrant different discount rates. A number of enforcement decisions resulted from the use of an incorrect discount rate. Examples included:

- Value in use should be calculated using a pre-tax discount rate and pre-tax cash flows. Using a pre-tax rate is not as simple as just grossing up a post-tax rate and is best determined using an iterative computation.
- The usual starting point for determining the asset-specific discount rate would be the WACC. However, an entity should be able to justify how they calculated their discount rate. Simply taking the WACC

and adding a percentage for prudence does not ensure that the asset specific risks are reflected.

- Different CGUs, especially when they are operating in different geographical locations, might warrant different discount rates.
- Inputs into a discount rate should reflect the current market assessment.

Disclosure requirements are often missed

The disclosures required by IAS 36 are extensive and can sometimes be overlooked. An overview of the required items is available in the [IFRS disclosure checklist](#).

Some of the main areas of enforcement focus on why an impairment arose and how the impairment test was performed. The key reminders relating to disclosure are:

- The events and circumstances that led to an impairment loss should be disclosed.
- The methodology of determining the recoverable amount and the underlying assumptions should be disclosed.

IAS 36 often requires the disclosure of market sensitive data. One issuer did not include all required disclosures on the grounds of confidentiality. The enforcer concluded that confidentiality was not a valid reason for incomplete disclosure.

Where to get help?

See [PwC In depth – Top 5 tips to impairment testing](#) for helpful hints on impairment testing and the preparation of cash flow models. A video version is available on [YouTube](#).

IFRS research is separating the facts from the hype



Anna Schweizer from Accounting Consulting Services takes a closer look at findings from Professor Christopher Nobes' recent research.

Are IFRS financial statements truly comparable? Are entities considering the appropriate qualitative characteristics when making changes to accounting policies? Has the IASB driven the extensive use of fair value?

Christopher Nobes is professor of accounting at Royal Holloway (University of London) and the University of Sydney. He was a member of the Board of the IASB's predecessor, the IASC. Professor Nobes researches the nature and causes of international differences in financial reporting. In this article we take a closer look at three areas of his research.

Global comparability of IFRSs

According to the preface to IFRS, the IASB is committed to developing in the public interest a single set of high quality, global

accounting standards that require transparent and comparable information in general purpose financial statements. However, the standards allow quite a few options. Does this reduce comparability of financial statements?

Research shows that IFRS practice is not consistent across countries. It will be no surprise to many that pre-IFRS national practice continues where permitted by IFRS. By this, the existence of national patterns of accounting can be documented within IFRS.

Christopher Nobes' research looks at annual reports of companies in the 'blue chip' indices of the largest five stock markets that use IFRS (Australia, France, Germany, Spain and UK).

A few examples:

- Income statement presentation is significantly influenced by pre-IFRS national practice. Australia, UK and Germany prefer presentation by function; whereas Spain prefers presentation by nature.
- French and Spanish entities are more inclined to show equity-accounted profits after finance items.
- Australia and UK are much more likely to show net assets in the statement of financial position than continental Europe.
- A clear majority of reporters in France, and about half of the reporters in Spain as well as Germany used the corridor method for accounting for post-employment benefits when this was still available. In Australia and the UK the vast majority accounted for actuarial gains / losses in OCI.
- A clear majority of reporters in Germany and France used proportionate consolidation of joint ventures when this was still allowed. In Australia, UK and Germany only a minority used this accounting policy choice. Nitassha Somai of Global Accounting Consulting Services examines the practical implications of IFRIC rejections related to IAS 7.

Conclusions

Professor Nobes offers a solution – to reduce the choices available in order to

increase global comparability. He believes that the same economic circumstances should be accounted for in the same way.

The IASB is (slowly) reducing choices in IFRS; for example the option of proportionate consolidation was recently removed.

Another view is that accounting policy choices allow territories to norm more slowly into one global standard and have thus increased the global acceptability of IFRS. Choices permit flexibility. The Framework states clearly that disclosure of accounting policies helps achieve comparability and in particular that comparability should not be confused with uniformity.

Read more on international differences in IFRS policy choices [here](#) (behind paywall).

Changes in accounting policies

The qualitative characteristics (QCs) of financial information from the Framework are intended to be used by entities when making accounting policy choices and changes. Changes in accounting policy choices are required to be explained providing a reason why the new policy provides 'reliable and more relevant' information.

Christopher Nobes and his team have analysed information from the annual reports of companies at the major national stock market indices in the following ten

countries: Australia, Switzerland, China, Germany, Spain, France, United Kingdom, Hong Kong, Italy, and South Africa. They base their findings on over 400 changes to accounting policy choices.

The majority of examined changes refer to QCs from the Framework, in particular to relevance, faithful representation, comparability and understandability. However, entities also frequently refer to transparency, which is not directly mentioned in the framework. QCs are more often referred to if the change relates to measurement (i.e. to a more important accounting policy decision), as opposed to changes relating to presentation and disclosure.

Conclusions

Accounting policies changes are often not explained well but the work performed by Professor Nobes provides evidence that management is alert to QCs. The question remains whether the reference to the qualitative criteria is really that helpful, given that most entity's disclosures of reasons for changes in accounting policies seem somewhat boilerplate.

Read more on the QCs used by entities when changing accounting policies [here](#) (behind paywall).

Negative interest rates, not just for banks!



A prolonged period of very low interest rates has surfaced some interesting (and unique) accounting issues. These issues don't just impact banks, all borrowers and lenders could be impacted and the IC is currently looking at several of the issues. Gabriela Martinez from Accounting Consulting Services takes a closer look at the implications of negative interest rates.

A few years ago, the idea of negative interest rates was not on anyone's radar screen. The recent financial crisis has seen central banks, particularly in developed economies, fighting deflation and recession by reducing interest rates. Those policies, particularly in Europe, have driven certain government and corporate debt yields down to record

lows. In certain cases, interest rates have gone negative. For example, a German government bond with a low coupon might sell in an auction at a premium. Thus, the real return is negative.

Negative interest rates matter for all entities that borrow or lend money as they could

introduce significant volatility to an entity's financial statements under IFRS. Some of the potential implications are considered below.

Hedging

Entities commonly use derivatives to hedge risk exposures such as interest rate risk. It is important to take a close look to understand any potential effects that negative interest rates could have on the hedge relationship.

Let's consider a cash flow hedge scenario. The hedged item is debt issued at a floating rate (the debt), which contains a zero percent floor (see discussion of embedded derivatives that follows). The debt was issued when interest rates were not negative and the floor is not accounted for separately. The hedging instrument is an interest rate swap (the IRS), which does not contain a mirroring embedded zero percent floor.

When interest rates go negative, there are no interest cash flows arising from the debt to offset those of the IRS. This results in hedge ineffectiveness. An entity needs to assess whether the level of ineffectiveness would preclude continuation of hedge accounting. If hedge accounting is discontinued, subsequent fair value changes of the IRS would be accounted for in profit or loss, resulting in volatility in the income statement.

Presentation of negative interest rates in financial statements

Another topic the IC has discussed is the presentation in the financial statements. The IC observed that interest resulting from a negative effective interest rate on a financial asset does not meet the definition of revenue in IAS 18 because it reflects a gross outflow, instead of a gross inflow, of economic benefits.

As a result, an entity could present negative interest as a separate line item on the face of the income statement either within 'net finance costs' (being finance income, finance costs and negative interest) or as an other expense category. It could also be included within finance costs.

Negative effective interest arising on a financial liability is a gross inflow and should be presented within interest income or other income. Negative interest income or expense could be presented separately on the face of the income statement or disclosed separately in the notes to the financial statements. Once management has selected a particular presentation, they should apply it consistently.

Embedded derivatives - debt instruments containing interest rate floors

Many debt instruments including bank debt and bonds commonly include 'embedded' features. A typical example would be a zero percent floor, which is a feature that limits the amount of interest to be paid/received to zero. That is, no negative cash flows arise on the loan. These floors are commonly found in floating rate loans (that is, loans bearing a benchmark rate, such as Libor, plus a credit spread).

This feature appears in many loans and in a 'normal' interest rate environment is not seen as a significant feature for the borrower or the lender. The assumption has been that the feature is unlikely to be relevant and cash flows of the arrangement will not be modified because of it. This means that the 'floor' was assessed as 'closely related' to the host instrument at the inception of a borrowing.

An entity is required under IAS 39 to assess whether an embedded floor is closely related (or not) to the loan. If not closely related, it must be accounted for separately from the loan, as if it was a stand-alone derivative, introducing volatility to the income statement.

The closely related assessment requires an entity, at inception of the instrument, to compare the embedded floor to the corresponding market rate. The lower interest rates are, the more important this assessment becomes.

Different views have been expressed on which market rate should be used for purposes of this assessment. Should it be the benchmark rate or should it be the

benchmark rate plus the credit spread. If the credit spread is not considered, it is likely that more embedded zero percent floors would be accounted for separately when the interest rates are negative.

Most companies, in practice, have used the benchmark rate and the credit spread. Thus, few companies are separating the embedded zero floor and accounting for it separately today.

This topic will be further discussed by the IC

in September. Companies that are affected should continue to monitor the discussions.

What should you be doing?

The extent to which negative interest rates could impact an entity's financial statements varies depending on particular facts and circumstances; careful consideration should be given. Have you assessed the effects that negative interest rates bring to your entity's financial statements? If not, now is the time to start!

Cannon Street Press

The IASB has issued its [work plan 2016-2020](#), and asks for comment on whether they have set the right priorities, and whether the projects identified are indeed the most pressing areas for improving IFRSs.

In parallel with this agenda consultation, the trustees of the IFRS foundation are also seeking input on the structure and effectiveness of the IFRS foundation, including the IASB.

Request for views on work plan

The request for views also discusses the effect of the 2011-2012 agenda consultation, and how the work plan developed in 2012-2015. The current work plan covers the time period until 2020 and is split into different categories, reflecting the different stages of the standard-setting process:

- **Research projects:** In response to the 2011-2012 agenda consultation, the IASB had introduced a research programme. Its purpose is to analyse possible problems based on evidence on the nature and extent of the perceived shortcoming and assessing potential ways to improve financial reporting. The main output of such research programs are discussion papers (DP) and research papers, for example the [DP on macro hedging](#), which helped the IASB decide whether

they should start a standards-level project.

- **Standard setting projects** aim at developing a new standard or substantially amending an existing standard. They are only started when the IASB has sufficient evidence that the problem is defined properly and that the staff have identified possible high-quality solutions that are implementable.
- **Maintenance and implementation projects** include projects to make minor amendments to existing standards, issuing formal interpretations, and post-implementation reviews (PIRs). In response to the 2011-2012 agenda consultation, the IASB has devoted more resources to maintenance and implementation projects, which also include post-implementation reviews (PIR).

In addition to these categories, the IASB has included the Conceptual Framework and the Disclosure Initiative as separate areas for the purpose of allocating resources, as they are cross-cutting and so significant that they justify separate mention.

Research projects

The projects that are currently in the research phase (per the IASB):

Assessment stage:

- Definition of a business
- Discount rates
- Goodwill and Impairment
- Income taxes
- Pollutant pricing mechanisms
- Post-employment benefits
- Primary financial statements
- Provisions, contingent liabilities and contingent assets

Development stage:

- Business combinations under common control
- Disclosure Initiative: Principles of Disclosure
- Dynamic risk management
- Equity Method
- Financial instruments with characteristics of equity

Inactive:

- Extractive activities / Intangible assets / Research and Development
- Foreign currency translation
- High inflation

Share-based payments The IASB will decide on which inactive projects to remove from its work plan, and which projects to add based on the comments received.

Standard setting projects

The request for views lists the following major projects including the announcement that it is likely that these will be completed in the first part of the work plan period:

- Insurance contracts
- Leases
- Disclosure Initiative:
 - Changes in accounting policies and estimates
 - Materiality practice statements
 - Principles of Disclosure

- Conceptual Framework
- Dynamic risk management
- Rate-regulated activities

Additionally the IASB noted the next review of the IFRS for SMEs, and post-issuance support for completed projects.

Maintenance and implementation projects

Most of the projects on the current list for interpretations, annual improvements or other narrow-scope amendments are expected to be completed within the next six months, and new projects are likely to replace them. The request for views includes an overview of the amount of maintenance and implementation projects finalised since the 2011/2012 agenda consultation.

Next steps

The 2015 request for views is open for comment until 31 December 2015. The IASB seeks feedback on the balance of their projects, the research programme, the major projects, and the level of change. Additionally the IASB raises the question of what frequency would be appropriate for agenda consultations.

Input to other activities of the IASB, such as education and content services, the IFRS taxonomy, and the impact of developments in technology are being considered in the separate review by the trustees. This review is open for comment until 30 November 2015. Additionally the trustees ask for views about the focus of the IASB, involvement in developments in wider corporate reporting, how the IASB can best support regulators in their efforts to improve digital access and in general what steps the IASB should take with regards to changes in technology and the consistent application of IFRS. Respond to the IASB's [invitation to comment here](#).

Have you seen the latest Pwc IFRS blogs

Mary Dolson demands sensible guidance for investment entities

Dave Walter sings the final countdown about the leasing standard



IFRS rejections in short – IAS 7

Nitassha Somai of Global Accounting Consulting Services examines the practical implications of IFRIC rejections related to IAS 7.

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 7 as per below.

The saying goes that 'cash is king'. Users of financial statements stay true to this saying and continue to focus on the ability of an entity to generate cash as well as how it has used that cash. The cash flow statement is the tool designed by standard setters to communicate this information, splitting cash flows into operating, investing and financing activities.

Theoretically, the preparation of a cash flow statement is not overly complex. Cash movements should be a simple function of reconciling cash received to cash paid. Nonetheless, in an accruals based framework, complexities arise. To date there have been four NIFRICs in relation to IAS 7.

Classification in cash flow statement

Value added tax (August 2005)

The IC was asked to consider whether cash flows reported should be measured as inclusive or exclusive of Value Added Tax ('VAT'). The IC acknowledged that IAS 7 does not address the treatment of VAT, but noted that it would be appropriate for entities to disclose whether they present their gross cash flows inclusive or exclusive of VAT.

The IC concluded that whilst different practices may emerge, this issue is not expected to be widespread. Where sales tax is recoverable we believe that cash flows should be shown net of tax. On the contra, where sales tax incurred by the entity is

irrecoverable, the cash flows should be shown gross.

Classification of expenditure (March 2008)

The IC was asked to consider the classification of expenditures in the cash flow statement in particular, those expenditures that might be recognised, according to the applicable standard, as an asset or an expense (for example, exploration and evaluation activities and advertising and promotional activities). There was diversity in practice for expenses which did not qualify for asset recognition. Whilst some entities included these expenses as part of operating activities, other entities included it as part of investing activities.

The IC recommended to the Board and IAS 7 was subsequently amended to make it explicit that only expenditures which result in a recognised asset can be classified as investing activities.

Definition of cash and cash equivalents

Classification of money market funds (July 2009)

The IC was asked to consider whether shares in money market funds that are readily convertible and rated as being subject to an insignificant risk of changes in value qualify as cash equivalents.

The IC noted that the purpose of holding cash equivalents is to meet short-term cash commitments. The critical considerations in making this assessment is that cash equivalents should be 'convertible to known amounts of cash' and 'subject to insignificant risk of changes in value'. The first consideration means that the amount of cash that will be received must be known at the time of the initial investment. Units cannot be considered cash equivalents simply because they can be converted to cash at any time at the then market price in an active market. An entity would also have to satisfy itself that any investment was subject to an insignificant risk of changes in value for it to be classified as a cash equivalent. At the time of the initial investment the risk of future changes in value is insignificant.

Possible approaches to the assessment include strict fund management policies to ensure that the investments in the fund meet all the requirements for cash and cash equivalents. This could include an investment in instruments with the highest credit quality or short-term instruments with high liquidity. Another approach would be to look through the fund to establish whether substantially all of its investments qualify individually as cash and cash equivalents.

Summary of IAS7 rejections

The IC did not expect significant diversity in practice on the basis that the guidance in IAS 7 is adequate and the purpose of holding the instrument and the satisfaction

of the criteria should be clear from its terms and conditions.

Identification of cash equivalents (May 2013)

The IC was asked to consider if the classification of investments as cash equivalents based on the remaining period to maturity as at balance sheet date would lead to a more consistent classification, as opposed to focusing on the investment's maturity at inception.

The IC noted that for an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. The IC observed that this three month presumption promotes consistency between entities in the classification of cash equivalents. It therefore concluded that in light of existing guidance, an interpretation or amendment to IAS 7 was not necessary. The IC does not expect significant diversity in practice.

Topic	Summary conclusion
VAT (August 2005)	The IC was asked to consider whether cash flows should be provided inclusive or exclusive of VAT. The IC concluded that cash flows can be presented either inclusive or exclusive of VAT, however, it would be appropriate for entities to disclose the approach
Classification of expenditure (March 2008)	The IC was asked to consider the classification of expenditures in the cash flow statement. The issue was referred to the IASB and IAS 7 was subsequently amended to explicitly state that only expenses that result in the recognition of an asset should be presented as investing activities.
Investments in money market funds (May 2009)	The IC was asked to consider if investments that are redeemable at any time meet the definition of cash equivalents. It was concluded that such instruments could meet the definition of cash equivalents when the investment was convertible to a known amount of cash and was subject to an insignificant risk of changes in value.
Identification of cash equivalents (May 2013)	The IC was asked to consider whether the classification of investments based on its remaining term to maturity would lead to a more consistent classification of investments. The IC did not add this issue to its agenda in light of the existing guidance and confirmed that investments should be classified based on their maturity from the date of acquisition.

The bit at the back.....



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