IFRS news

April 2020

A focus on IFRS 9 expected credit losses for corporate entities

How corporate entities can apply the requirements of IFRS 9 expected credit losses (ECL) during the COVID-19 pandemic – In the Spotlight

At a glance

The COVID-19 pandemic has had and will continue to have far-reaching implications. In many parts of the world, governments have brought in never-before-seen measures including mass quarantines, social distancing, border closures, shut-downs of non-essential services and considerable (in some cases, unlimited) commitments to provide financial support to affected businesses and individuals. Just as the medical implications are emerging and evolving at breakneck speed, so too are those related to the economic and credit environment.

COVID-19 will impact many areas of accounting and reporting for all industries, as outlined in our publication In depth: Accounting Implications of the Effects of Coronavirus. The IASB issued a short document on IFRS 9 and COVID-19 in March 2020. Regulatory authorities have also provided additional guidance for financial institutions. But companies in all industries are facing additional working capital pressure and a likely increase in the credit risk of their receivables. In this Spotlight we focus on the implications for corporate entities (that is, non-financial institutions) when measuring expected credit losses (ECL) on trade receivables, contract assets, lease receivables, intercompany loans and any other financial assets subject to IFRS 9's ECL requirements.

While this Spotlight focuses on ECL, there will be other IFRS 9-related issues including the ability to continue hedge accounting and the implications of debt modifications or working capital improvement projects. Entities are reminded to consider all potential accounting issues. Further guidance on these and other issues is given in the In depth referred to above.

1. Key messages in the IASB document

As noted above, in March 2020 the IASB issued a short document **on the application of IFRS 9 in the light of uncertainty arising from the COVID-19 pandemic**. The IASB document is intended to support the consistent and robust application of IFRS 9. It acknowledges that estimating ECL is challenging in the current circumstances and that 'it is likely to be difficult at this time to incorporate the specific effects of COVID-19 and government support measures on a reasonable and supportable basis.' However, the IASB is also clear that 'changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings.'

Key messages for all entities, including non-financial institutions, include:

- Companies should use all reasonable and supportable information available – historic, current and forward-looking where possible; and
- IFRS 9 does not prescribe any bright lines or a mechanistic approach.

We consider below the implications of this and other guidance for corporate entities.

2. Measuring and presenting expected credit losses (ECLs) – reminder of the core principles and implications of the changing environment

While the uncertainties arising from COVID-19 are substantial and circumstances are certain to change, we do not expect this to preclude entities from estimating their ECLs. Estimating ECLs is challenging, but that does not mean it is impossible to estimate an impact based on the reasonable and supportable information that is available. On transition to IFRS 9, few corporates recognised a material increase in their impairment provisions but ECLs are likely to be higher in the current environment. A few things that may be helpful to keep in mind are:

- Significant judgement will need to be applied in assessing the range of potential outcomes so as to meet IFRS 9's requirement that the ECL reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes, particularly for longer term receivables such as loan receivables or trade debtors and contract assets with a significant financing component. An unbiased estimate is one that is neither overly optimistic, nor overly pessimistic.
- Given the speed with which events are unfolding, measuring ECLs for March 2020 year ends or interim reports is likely to be particularly challenging. Entities will need to develop an estimate based on the best available data about past events, current conditions and forecasts of future economic conditions. Adjustments to expected loss rates in provision matrices and overlays to formal models (where used) will be needed. Updated facts and circumstances should continue to be monitored for any new information relevant to assessing the conditions at the reporting date.
- In terms of the methodology used to estimate ECL, no one size will fit all, and different approaches may work best depending on factors such as local conditions and available data. Certain debtors may receive government support in some countries, while not in others. Whilst such support is designed to compensate for cash flow shortages, it will take time for some of the measures to be put in

place and, even once in place, entities may prioritise paying items such as rent or employees over other suppliers. Hence the effects of the government support will need to be carefully considered when factoring this into the likelihood of delayed payment or customer default.

- IFRS 9 always required entities to consider multiple scenarios. However, many corporates might not have done so because it did not make a material difference to the outcome in a benign economic environment. That approach may no longer be appropriate, particularly for entities with longer term loan receivables, and for trade debtors and contract assets where there is a significant financing component.

  In many countries there is little doubt that economic conditions have deteriorated, and this should be reflected in the macro economic scenarios applied by an entity and the weighting applied to those scenarios. For example, entities might add one or more scenarios to reflect a more severe downside(s) and/or to increase the weighting allocated to downside scenarios. Core scenarios which assume a very low probability of default may be difficult to support. Estimates are likely to be refined as additional information becomes available that is relevant to assessing conditions at the reporting date.

- Only financial guarantees or other forms of credit insurance that are integral to the financial asset may be taken into account in measuring the ECL. A common example in some groups is where subsidiaries are not permitted to sell to particular customers unless credit insurance or a letter of credit is in place. Even where entities can take the financial guarantee or credit insurance into account, they should remember that this can only reduce the risk of loss – it does not reduce the likelihood of default. Management should also consider whether the party providing the guarantee or insurance is likely to be able to meet its obligations when called upon. This may be particularly relevant for intercompany guarantees of loans in standalone accounts.
- Where contractual payment dates are extended or amounts are expected to be received later than when contractually due, this may give rise to an ECL unless either additional compensation is received for the lost time value of money, or the EIR is 0%. This may particularly affect longer term receivables such as lease receivables, some contract assets and loans. However, in territories where interest rates are low, the impact may be small relative to the impact of credit risk (that is, risk that amounts are never paid).
- IAS 1 para 82 requires presentation of IFRS 9 impairment losses on the face of the income statement as a separate line item. Impairment losses should not be netted off revenue. This separate presentation might not have been given in previous years if the ECL and year on year movements were immaterial. However, there will likely be more focus on this requirement in the wake of COVID-19 and increasing credit risk.
- Disclosures are a critical component of ECL reporting, given the level of measurement uncertainty resulting from COVID-19 (see 5 below).

3. Implications for trade receivables, lease receivables and contract assets measured using the simplified approach

Financial instruments within the scope of IFRS 9's ECL model include trade and other receivables, loan receivables and other debt investments not recognised at fair value through profit or loss (including intercompany loans), contract assets, lease receivables, financial guarantees and loan commitments.

For many corporate groups the main balances subject to ECL will be trade receivables. As required by IFRS 9, a simplified approach of using lifetime ECL is used for measuring the ECL for such trade receivables and contract assets if they do not contain a significant financing component. Entities often calculate ECLs by using a provision matrix. The simplified approach is also permitted for lease receivables and receivables with a significant financing component, but this is an accounting policy choice.

However, forward looking information (including macro-economic information) must still be considered in assessing the credit risk on those balances and in measuring ECL. As noted above, forward-looking information might include one or more downside scenarios related to the spread of COVID-19.

Companies often stratify their receivables into different groupings before applying a provision matrix. For example, a company might sell to customers in different industries some of which are impacted by COVID-19 to a greater degree than others and therefore be exposed to different risks of default. Other factors that might be considered in such stratification would include geographical regions, product type, customer ratings, collateral, and the nature of the customer (for example, wholesale vs. retail).

In considering stratification, it is important to first understand the drivers of credit risk for the underlying receivables and how these may have changed in light of the current pandemic. The level of stratification required is often a matter of significant judgment and in developing segments an entity should consider where further segmentation might be needed. Stratification may go down to the individual customer level in some cases, often described as a specific bad debt provision. For example, where a particular customer is known to be in financial difficulty, it may require an increased provision compared to historical averages over all ageing categories. It is important to consider and avoid any double counting of losses in these situations.

In attempting to model the impact of the pandemic, companies might, as a starting point, look to the behaviour of their customers during previous recessions, thereby using historic credit loss experience as an estimate of future losses. However, given restrictions on both movement and economic activity of a similar magnitude are unlikely to have been experienced in most jurisdictions in modern times, adjustments will need to be made to that historical information to make it supportable in the current period. This could increase the expected risk of default for each time bucket in the provision matrix.

Similarly, some customers may take longer than normal to pay, thus increasing the volume of debtors in the overdue buckets. The extent to which this delay is due to credit risk or is merely an indication of operational issues (e.g. if employees are not able to access their offices) will need to be carefully considered. Many supplier arrangements include the right to charge interest on overdue payments, but in practice it is not always implemented in order to keep good customer relationships. If entities do not intend to charge interest, then it should not be accrued.

The likelihood of debtors paying, and the effect of any government initiatives will also need to be revisited in measuring ECL at the end of each reporting period.

Further information on calculating ECL in a corporate scenario is given in our publication on IFRS 9 impairment practice guide provision matrix: In depth UK2018-03.

4. Loan receivables, including intercompany balances and other assets not measured using the simplified approach – identifying significant increases in credit risk (SICR)

Where entities are not permitted to follow the simplified approach, or have opted not to, additional information may be needed in order to determine whether a significant increase in credit risk has occurred, and hence whether a lifetime, rather than 12-month, ECL is required. This will apply to all receivables to which the full IFRS 9 model is applied including loan receivables and most intercompany balances. Factors to consider include:

- **Risk of default** – SICR is based on the likelihood of a default arising, and not on the likelihood of losses. Hence, some government relief programmes may not impact SICR assessments. Those programmes that provide cash directly to debtors quickly and thus mitigate the risk of default should be considered but those that make payments directly to the reporting entity to compensate for any losses will not reduce the risk of default on the underlying receivables. If the risk of default has increased, then this may mean that a SICR has arisen, even in cases where it is expected that any losses that arise will be fully recovered. See the In depth: Accounting Implications of the Effects of Coronavirus for further guidance on when such government relief programmes might need to be accounting for or disclosed as government grants.
- **Payment holidays** – where a corporate grants an extension of terms to a counterparty (sometimes referred to as a 'payment holiday') management should assess whether or not this indicates there has been a significant increase in credit risk, given IFRS 9 B5.5.17(m) includes a payment holiday as a potential indicator of SICR. The IASB's document referred to above notes that 'the extension of payment holidays to all borrowers in particular classes of financial instruments should not automatically result in all those instruments being considered to have suffered an SICR'. However,such 'blanket' payment holidays are not often granted by corporates and whether there has been a SICR should be assessed on a case-by-case basis in the light of the particular facts and circumstances. This may be of most relevance to lessors and they more detailed guidance in the Banking industry Spotlight on ECL provides further guidance.
- **Low credit risk (LCR) exemption from assessing SICR** – The LCR exemption is typically used for securities with an investment grade credit rating from an external credit rating agency or, in a group scenario, for intercompany receivables arising when external debt is transferred from a Treasury or FinCo to an Operating company. However, there is often a time lag between the credit risk increasing and a downgrade of the external credit rating occurring. IFRS 9 only gives an external investment grade credit rating as an example of what might be considered to have low credit risk – the broader principle is that 'low credit risk' should be determined with reference to the perspective of a market participant. [IFRS 9 para B5.5.22]. Therefore, even if the external credit rating of a particular debtor is still investment grade, if that is only due to a time lag and a market participant would no longer consider the instrument to have low credit risk, the LCR exemption will not apply and the instrument will need to be assessed for SICR. Management should take this into account when assessing whether the LCR exemption still applies for intercompany loans that were previously deemed to have the same credit rating as other instruments issued by the borrower.
- **Materiality judgements** – Simplifications in previous IFRS 9 ECL measurements justified on the grounds they have no material impact should be revisited in the current environment.
- Further guidance on the calculations required is given in our publication on IFRS 9 Impairment – intercompany loans: PwC In depth 2018-07.

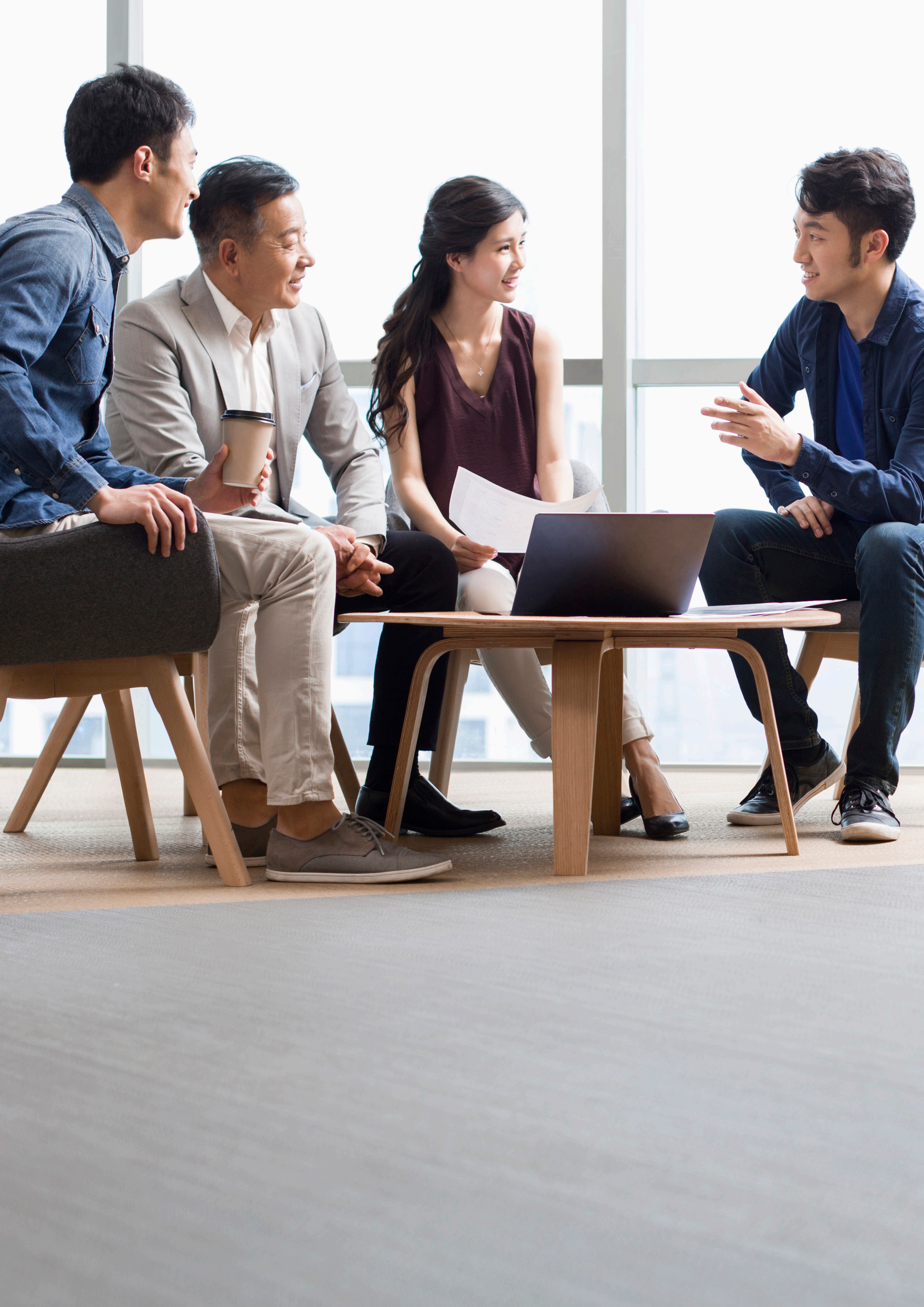
5. Interim reporting under IAS 34 and other disclosure considerations

Many regulators around the world are revising timelines and requirements for interim reporting. When entities do issue interim reports under IAS 34, it will be important to keep in mind the overarching requirement to explain events and transactions since the end of the last annual reporting period that are significant to understanding changes in financial position and performance. Key considerations in meeting that requirement, and when preparing other forms of interim reports, are likely to include:

- **Critical estimates** – Clearly identifying and explaining the critical estimates used in determining ECL will be important. Whilst 31 December 2019 disclosures on critical estimates will in many cases constitute a good starting point, a simple roll-forward of these disclosures is unlikely to be appropriate. There are likely to be new aspects of accounting that have become critical due to the changes in the economic environment and in market dynamics. Hence, past disclosures on previously identified critical estimates may no longer be relevant. If the size of ECLs has become a significant estimate, some regulators expect sensitivities to be provided as IAS 1 suggests that this would be a useful disclosure of an entity's assumptions about the future.
- **Telling the story** – Disclosures should reflect factors that are specific to the entity rather than being boilerplate; and should tell the story of how the estimate was developed. Such disclosures would include describing how the credit and other risks that the entity is exposed to have been impacted by COVID-19, how the impacts of COVID-19 have been incorporated into the ECL estimate, and the extent to which there is uncertainty and hence how estimates might change in the future.
- **Credit risk concentrations and management practices** – In the past corporate entities may not have given much detail on credit risks or their management practices but the level of granularity demanded by investors will likely increase where they have material credit exposures. For example, entities may wish to expand their disclosure of exposures to large and smaller entities or to certain industries, for example, transport or retail and further explain the use of insurance/letters of credit and credit risk management practices.

Conclusion

COVID-19 has given rise to unprecedented challenges that have affected virtually every aspect of modern life. The economic implications of the virus will have a consequent impact on many aspects of accounting and financial reporting. We hope this Spotlight will help you and your advisers as you navigate the key issues as they relate to IFRS 9 ECLs for Corporate entities.



A banking industry focus on IFRS 9 expected credit losses

COVID-19: Top 5 IFRS Accounting Issues for Banks – In the Spotlight

At a glance

The COVID-19 pandemic has had and will continue to have far-reaching implications. In many parts of the world, governments have brought in never-before-seen measures including mass quarantines, social distancing, border closures, shut-downs of non-essential services and considerable (in some cases, unlimited) commitments to provide financial support to affected businesses and individuals. Just as the medical implications are emerging and evolving at breakneck speed, so too are those related to the economic and credit environment.

COVID-19 will impact many areas of accounting and reporting for all industries, as outlined in our publication In depth: Accounting Implications of the Effects of Coronavirus. For banks, additional challenges are likely to arise. In this Spotlight we provide our insights into what we believe to be the Top 5 issues for banks. These are:

1. Measuring expected credit losses (ECLs)
2. Identifying significant increases in credit risk (SICR)
3. Modifications and forbearance
4. Interim reporting under IAS 34 and other disclosure considerations
5. Government relief programmes

While this Spotlight focuses on the Top 5 issues, many others are certain to arise. As the situation continues to evolve, so too will the consequential accounting issues. For these reasons, the following is not an exhaustive list of all relevant accounting considerations. And while issues have been grouped under 5 headings, they will in many cases be interrelated.

1. Measuring expected credit losses (ECLs)

While the uncertainties arising from COVID-19 are substantial and circumstances are sure to change, we do not expect this to preclude banks from estimating their expected credit losses (ECLs). Estimating ECLs is challenging, but that does not mean it is impossible to estimate an impact based on the reasonable and supportable information that is available. A few things that may be helpful to keep in mind are that:

- Significant judgement will need to be applied in assessing the range of potential outcomes so as to meet IFRS 9's requirement that the ECL reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. An unbiased estimate is one that is neither overly optimistic, nor overly pessimistic.
- Given the speed with which events are unfolding, measuring ECLs at Q1 2020 is likely to be particularly challenging. Banks will need to develop an estimate based on the best available data about past events, current conditions and forecasts of future economic conditions. To the extent it is not possible to reflect the impact of COVID-19 in an institution's models (and this is likely to be the case for many institutions, at least at Q1 2020), post-model adjustments or overlays will need to be considered. Updated facts and circumstances should continue to be monitored for any new information relevant to assessing the conditions at the reporting date.
- In terms of the methodology used to estimate ECL, no one size will fit all and different approaches may work best depending on factors such as local conditions, portfolio exposures, available data and existing models. Certain businesses or individuals may receive government support in some countries, while not in others.
- For interim reporting, in particular for Q1 2020, many institutions may not be able to perform a comprehensive 'bottom-up' analysis using loan-level probabilities of default that fully reflect all potential risks. Rather, it might be more appropriate to use top-down approaches (e.g. collective assessments or overlays) that focus on those segments that are most vulnerable.
- There is little doubt that economic conditions have deteriorated and this should be reflected in the macroeconomic scenarios applied by an institution and their weightings. In some cases, the prior period downside scenario may be an appropriate starting point for the current base case. Estimates are likely to be refined as additional information becomes available that is relevant to assessing conditions at the reporting date.
- Under IFRS 9's ECL model, an expected credit loss will arise even where full recovery is expected on a loan, if payment is delayed and interest does not accrue during the deferral period at the effective interest rate of the loan. This is because there is a loss in terms of the present value of the cash flows.
- Disclosures are a critical component of ECL reporting, in particular given the level of measurement uncertainty resulting from COVID-19 (see 4 below).

2. Identifying significant increases in credit risk (SICR)

A key element in determining ECL is the assessment of whether or not a significant increase in credit risk has occurred, and hence whether a lifetime, rather than 12-month, ECL is required. In many cases and in particular at Q1 2020, it is unlikely that banks will have sufficient timely data to update loan-level probabilities of default which are often a core element of assessing SICR. As a result, a more likely approach may be collective assessments of qualitative factors and overlays, focusing on vulnerable segments of the loan book. Other factors to consider include the following:

- Assuming either that all stage 1 exposures move to stage 2 or 3, or alternatively that no exposures move to stage 2 or 3, is unlikely to be appropriate in many cases. The extension of blanket financial support to all borrowers in a certain class (e.g. all household mortgages) does not automatically mean that all such borrowers have experienced a significant increase in credit risk. Nevertheless, and notwithstanding extensive government financial support, debt levels are expected to rise and this will typically affect credit risk assessments. Judgements therefore need to be made to distinguish between those exposures that are significantly affected and those which are affected to a lesser extent, including within individual segments or portfolios.
- SICR is based on the likelihood of a default arising, and not on the likelihood of losses. Hence, some government relief programmes may not impact SICR assessments. For example, those programmes that provide cash directly to borrowers quickly and thus mitigate the risk of default should be considered, whereas those which provide funding or guarantees to financial institutions and only mitigate the losses incurred by those institutions should not. This may mean that a SICR has arisen, even in cases where it is expected that any losses that arise will be fully recovered by the bank.
- Staging might have a smaller impact on the overall ECL than other judgements and estimates since COVID-19-related defaults might be expected to take place quickly. For instance, this would be the case if COVID-related defaults are expected to arise within the next 12 months and so are already captured within Stage 1 ECLs.

3. Modifications and forbearance

To help borrowers cope with the financial consequences of COVID-19, many banks and governments have announced various types of relief programmes that involve payment holidays, such as:

- Blanket moratoriums on debt payments for all borrowers in a certain class (e.g. all mortgages); and
- Case-by-case relief to:
  - Those most affected;
  - Any who request relief; and/or
  - Those considered to have a good propensity to pay absent COVID-19.

Typically, these programmes require continued accrual of interest during the period of the payment holiday[1]. Given the unique features of many of these programmes, when determining the extent to which they give rise to a SICR past practices for payment holidays may not be appropriate. In particular, blanket moratoriums are unlikely to indicate all the loans in the affected population have suffered a SICR. However, certain customers within that population would be expected to have suffered a SICR, and so alternative ways of identifying this group would need to be considered. For Q1 2020, a starting point may be to use pre-COVID-19 risk ratings to determine which exposures were previously 'closest to the line' and hence are more likely to have suffered a SICR.

[1] Where that is not the case – i.e. where interest is forgiven – additional considerations will likely apply.

4. Interim reporting under IAS 34 and other disclosure considerations

Many regulators around the world are revising timelines and requirements for interim reporting. When banks do issue interim reports under IAS 34, it will be important to keep in mind the overarching requirement to explain events and transactions since the end of the last annual reporting period that are significant to understanding changes in financial position and performance. Key considerations in meeting that requirement, and when preparing other forms of interim reports, are likely to include:

- **Critical estimates** – Clearly identifying and explaining the critical estimates used in determining ECL will be important. Whilst 31 December 2019 disclosures on critical estimates will in many cases constitute a good starting point, a simple roll-forward of these disclosures is unlikely to be appropriate. There are likely to be new aspects of accounting that have become critical due to the changes in the economic environment and in market dynamics. Hence, past disclosures on previously identified critical estimates may no longer be relevant. In addition, those banks which previously disclosed numerical sensitivities may be unable to 're-base' them at Q1 2020 to reflect the current uncertainty in a meaningful way. Indeed, such numerical sensitivities might actually risk misleading users if they are likely to be quickly superseded, in which case temporarily replacing them with a more qualitative analysis might provide more relevant information to users.
- **Telling the story** – Disclosures should reflect factors that are specific to the bank rather than being boilerplate, and should tell the story of how the estimate was developed. Such disclosures would include describing how the credit and other risks that the bank is exposed to have been impacted by COVID-19, how the impacts of COVID-19 have been incorporated into the ECL estimate, and the extent to which there is uncertainty and hence estimates might change in the future.
- **Credit risk concentrations** – Given the different impacts across sectors, updating previously disclosed analysis of portfolios by industry or region will be important. As was evident during the 2008 financial crisis, the level of granularity demanded by users will likely increase. For example, in the past a bank may have disclosed its exposure to the transport sector without further disaggregation. This may now need to be sub-analysed to help users understand the different underlying exposures and risks, for example by analysing the exposures into airlines, state-backed train companies, and haulage and freight companies.
- **Credit risk management practices** – The ways that banks manage credit risk are very likely to change, particularly given the large scale programmes to grant payment holidays and other reliefs that are being offered or mandated in many territories. It will be important to ensure there is a clear explanation of these programmes and their effect on credit risk practices, as well as any expected or potential impacts on the bank's financial reporting.
- **Fair values** – Significant changes in fair value are explicitly required to be disclosed under IAS 34, as are significant transfers between levels in the fair value hierarchy. Given recent decreases in asset prices and liquidity in many markets, banks should provide sufficient information for users to understand these changes and their impacts. Where there have not been significant impacts, disclosing this fact may also be material information, given the risk of what might otherwise be assumed in the current environment.

5. Government relief programmes

Many governments, central banks and other agencies are developing programmes to provide economic support. Where this intervention is made through the banking system (e.g. by providing funding or guarantees to banks at potentially advantageous rates or terms), a key accounting consideration is whether an element of the transaction is a government grant. This can impact the timing of recognition of the effects of the relief, the presentation of those effects and what disclosures may be required.

In order to determine the appropriate accounting treatment, it will be important to understand the exact details of each particular support arrangement. Some of the factors to consider when assessing the accounting treatment are:

- Whether the programme is on arms' length terms based on past transactions or market pricing, or can be considered to be 'on-market' for transactions of this kind in the current environment (i.e. including transactions with a government or government agency).
- If a programme does contain a government grant, whether there is 'reasonable assurance' that the grant will be received as required by paragraph 7 of IAS 20, taking account of factors such as:
  – Which aspects of the support remain uncertain and how critical are they?
  – Which transactions, with which counterparties, will be eligible for relief under the programme and how will that relief or benefit be received by the bank?
  – Will the government be able to deliver the stated reliefs, considering practical challenges as well as its ability to pay?
  – Are any subsequent clarifications adjusting post balance sheet events for accounting purposes?
- If recognition of a government grant is determined to be appropriate, the timing of recognition of the benefit in profit or loss, and its presentation and disclosure.

Conclusion

COVID-19 has given rise to unprecedented challenges that have affected virtually every aspect of modern life. The economic implications of the virus will have a consequent impact on many aspects of accounting and financial reporting. Banks face some of the biggest accounting challenges, and we hope this Spotlight will help you and your advisers as you navigate the key issues.

A look at current financial reporting issues

IFRS 16 accounting and disclosures – What to look out for

At a glance

This applies to all entities that apply IFRS 16, 'Leases'.

Transitioning to a new accounting standard is not straightforward. With the introduction of IFRS 16, there are several accounting and disclosure considerations which need to be taken into account.

Below are some common mistakes to look out for and questions to ask yourself when you are assessing IFRS 16 accounting and disclosures.

What is the issue?

This In brief provides you with a number of reminders on IFRS 16, the new accounting standard for leases, along with references to useful sections of Inform where you can find more information.

What is the impact and for whom?

Lease term

- The lease term cannot exceed the period for which the lease is enforceable. The IFRS Interpretations Committee (IC) concluded that the enforceable period of a lease under IFRS 16 reflects broader economics, not just legal rights and termination cash payments. Lessees that had previously interpreted the enforceable period more narrowly will need to consider the impact, which could increase recognised lease liabilities. See In-brief 2019-15 for further details.

Useful life of non-removable leasehold improvements

- The IC concluded that, when assessing the useful life of leasehold improvements, the lessee should consider whether the lease term of the related lease is shorter than the economic life of the leasehold improvements and, if so, whether the lessee expects to use the leasehold improvements beyond that lease term. If the improvements will not be used beyond the lease term, the useful life of the leasehold improvements is the same as the lease term.

Restoration costs

- Restoration provisions – Restoration provisions are required where a lessee is obliged to return the leased asset to the lessor in a specific condition or to restore the site on which the leased asset has been located. Paragraph 24(d) of IFRS 16 states that the initial measurement of the right-of-use asset includes removal and restoration costs (as illustrated in IFRS manual of accounting FAQ 16.85.6 and FAQ 15.71.1).
- Provisions for wear and tear are recognised as an expense over the tenancy period, since IFRS 16 only allows restoration and removal costs to be capitalised if they relate to an asset's installation, construction or acquisition (as illustrated in IFRS manual of accounting FAQ 16.85.5). This is consistent with how such costs should previously have been accounted for under IAS 17.

Presentation in the cash flow statement

- The portion of lease payments that represents cash payments for the principal portion of the lease liabilities is presented as cash flows resulting from financing activities.
- The portion of lease payments that represents the interest portion is presented either as operating cash flows or as cash flows resulting from financing activities in accordance with the entity's accounting policy regarding the presentation of interest payments (IFRS manual of accounting para 7.34).
- Lease payments which were not included in the measurement of the lease liabilities (including certain variable payments, short-term leases and leases of low-value assets) are presented as operating cash flows.
- Payments made before the commencement of a lease are generally classified as investing cash flows, because these are cash payments for the acquisition of the right-of-use asset.

Disclosures about future cash outflows that are not reflected in the measurement of lease liabilities and IFRS 7 disclosures

- Paragraph 59 of IFRS 16 requires disclosures about future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from:
  - variable lease payments (as described in para B49);
  - extension options and termination options (as described in para B50);
  - residual value guarantees (as described in para B51); and
  - leases not yet commenced to which the lessee is committed.
- Disclosures of lease obligations are excluded from the scope of IAS 39 or IFRS 9; however, such obligations are financial instruments, and therefore certain IFRS 7 disclosures are required, such as exposure to market risk (for example, currency risk, or interest rate risk for leases that vary with a benchmark interest rate).

- IFRS 9 category disclosures, as set out in paragraph 8 of IFRS 7, do not apply to an IFRS 16 lease obligation.
- The same maturity analysis disclosure requirements apply to lease liabilities as those applied to other financial liabilities. These can be disclosed either in a separate note or as a separate line in the disclosure required for other financial liabilities.

IAS 7 financing activities reconciliation

- Paragraph 44A of IAS 7 requires entities to disclose the changes in liabilities that arise from financing activities, including both financing cash flows and non-cash changes. This disclosure should include IFRS 16 lease liabilities, because these are a form of financing.

Impact on other standards

- As a reminder, we have also issued In-depth 2019-02 which outlines the interaction between IFRS 16 and other standards such as IAS 36, 'Impairment of Assets'.

Which entities does this guidance apply to?

The guidance in this In brief applies to all engagement teams performing audits of IFRS and FRS 101 annual reports.

When does it apply?

IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019.

Where do I get more details?

Further guidance on the application of the accounting standards for leases can be found in the IFRS manual of accounting chapter 15 (subscription required – apply for a free trial of Inform at pwc.com/inform.)

A look at current financial reporting issues

Translation of hyperinflationary foreign operations (IAS 29/IAS 21) – In brief

At a glance

The IFRS Interpretations Committee (IC) received a request asking: (1) how an entity with a non-hyperinflationary presentation currency should present differences that arise on restating and translating the opening financial position of a hyperinflationary foreign operation; and (2) whether the foreign currency translation reserve should be reclassified when a foreign operation becomes hyperinflationary.

The IC concluded that an entity should present translation differences in OCI and not in equity. The IC also concluded that an entity does not reclassify the accumulated foreign currency translation reserve to a component of equity that is not subsequently reclassified to profit or loss when a foreign operation becomes hyperinflationary.

The agenda decision is relevant to entities with foreign operations in hyperinflationary economies, particularly those that currently apply a different policy for recognising restatement and translation effects on opening equity. These entities should reconsider their existing policies in the light of the IC's conclusion and determine whether any changes are required.

What is the issue?

IAS 21 requires an entity to restate the results and financial position of a hyperinflationary foreign operation by applying IAS 29 before applying the translation method set out in IAS 21. This will have two effects:

1. a restatement effect resulting from restating the entity's interest in the equity of the hyperinflationary foreign operation (IAS 29); and
2. a translation effect resulting from translating the entity's interest in the equity of the hyperinflationary foreign operation at a closing rate that differs from the previous closing rate (IAS 21).

However, neither IAS 21 nor IAS 29 explains specifically how these effects should be presented in the consolidated financial statements, and the IC observed that there was mixed practice.

IAS 21 also requires the results and financial position of a foreign operation that does not have the functional currency of a hyperinflationary economy to be translated into the presentation currency in each period, and any translation differences to be recognised in a foreign currency translation reserve within equity until the foreign operation is sold. However, neither IAS 21 nor IAS 29 explains specifically how this reserve is dealt with when the foreign operation becomes hyperinflationary.

The IC has issued an agenda decision on the interaction between IAS 21 and IAS 29 that addresses both of these issues.

How does an entity present any exchange difference arising from translating a hyperinflationary foreign operation?

The IC concluded that an exchange difference can be defined either as a translation effect alone or as the combined effect of restatement and translation. The way in which an entity defines exchange difference will determine the presentation of these effects.

IAS 21 requires the recognition of exchange differences in profit or loss or other comprehensive income (OCI). As a result, it would not be appropriate to recognise all translation differences directly in equity, even if a foreign operation has a functional currency of a hyperinflationary economy. The presentation of the restatement and translation effects will therefore follow one of two approaches:

- the combined effect of the restate/translate approach in OCI; or
- the translation effect in OCI and the restatement effect in equity.

Should an entity reclassify its currency translation reserve in equity when a foreign operation first becomes hyperinflationary?

The IC concluded that an entity would not reclassify the accumulated foreign currency translation reserve to a component of equity that is not subsequently reclassified to the income statement when a foreign operation becomes hyperinflationary. The accumulated foreign currency translation reserve is reclassified to profit or loss only when the foreign operation is sold (or partially sold).

What is the impact and for whom?

The agenda decision will affect entities with foreign operations in hyperinflationary economies, particularly those that currently apply a policy of recognising restatement and translation effects in equity. In particular, the agenda decision means that the accumulated foreign currency translation reserve at the date when a foreign operation becomes hyperinflationary, together with translation differences that arise subsequently, will remain in the translation reserve until the foreign operation is sold. The impact on the amount of translation differences reclassified on a subsequent disposal could be material.

Entities that currently apply a different policy should reconsider their existing presentation policies in the light of the IC's comments and determine whether any changes are required.

When does it apply?

The agenda decision has no formal effective date. The IC has noted that agenda decisions might often result in explanatory material that was not previously available, which might cause an entity to change an accounting policy. The IASB expects that an entity would be entitled to sufficient time to make that determination and implement any change. Any change in policy should be applied retrospectively, and comparative amounts should be restated.

Where do I get more details?

For more information, refer to the agenda decision or please contact Tony Debell (tony.m.debell@pwc.com) or Elizabeth Dicks (elizabeth.a.dicks@pwc.com).

Word on the Wharf

The Board met remotely on 21 and 23 April 2020.

The topics, in order of discussion, were as follows:

- Amendments to IFRS 17 Insurance Contracts
- Financial Instruments with Characteristics of Equity
- Post-implementation Reviews of IFRS 10, IFRS 11 and IFRS 12
- Maintenance and consistent application
- Management Commentary
- Review of the IFRS for SMEs Standard
- Disclosure Initiative—Subsidiaries that are SMEs

Coronavirus (COVID-19)

Looking for all our COVID-19 related guidance on IFRS? See Inform's dedicated topic homepage.

Contacts

For further help on IFRS technical issues, contact:

Andri Stavrou
Tel: +30 210 687 4703
E: andri.stavrou@pwc.com

Financial instruments and financial services

Kyriaki Plastira
Tel: +30 210 687 4425
E: kyriaki.plastira@pwc.com

Revenue recognition, liabilities and other areas

Vart Kassapis
Tel: +30 210 687 4757
E: vart.kassapis@pwc.com

Business combinations and adoption of IFRS

Iliana Kostoula
Tel: +30 210 687 4044
E: iliana.kostoula@pwc.com

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2020-04-22_RITM2899876