IFRS news

May 2020

A look at current financial reporting issues

IFRS 16 COVID-19 rent concessions amendment

At a glance

As a result of the coronavirus (COVID-19) pandemic, rent concessions have been granted to lessees. Such concessions might take a variety of forms, including payment holidays and deferral of lease payments. On 28 May 2020, the IASB published an amendment to IFRS 16 that provides an optional practical expedient for lessees from assessing whether a rent concession related to COVID-19 is a lease modification. Lessees can elect to account for such rent concessions in the same way as they would if they were not lease modifications. In many cases, this will result in accounting for the concession as variable lease payments in the period(s) in which the event or condition that triggers the reduced payment occurs.

What is the issue?

In many territories, rent concessions have been, or are expected to be, provided to lessees as a result of the COVID-19 pandemic. Such concessions might take a variety of forms, including payment holidays and deferral of lease payments for a period of time, sometimes followed by increased rent payments in future periods. IFRS 16 contains requirements that apply to such rent concessions. The IASB has noted, however, that applying those requirements to a potentially large volume of rent concessions related to COVID-19 could be complex – particularly in the light of the many other challenges that stakeholders face during the pandemic.

As a result, the IASB has provided lessees (but not lessors) with relief in the form of an optional exemption from assessing whether a rent concession related to COVID-19 is a lease modification. Lessees can elect to account for rent concessions in the same way as they would if they were not lease modifications. In many cases, this will result in accounting for the concession as a variable lease payment.

The practical expedient only applies to rent concessions occurring as a direct consequence of the COVID-19 pandemic and only if all of the following conditions are met:

- the change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change;
- any reduction in lease payments affects only payments due on or before 30 June 2021; and
- there is no substantive change to other terms and conditions of the lease.

Lessees that apply the exemption will need to disclose that fact, as well as the amount recognised in profit or loss arising from COVID-19-related rent concessions. If a lessee chooses to apply the practical expedient to a lease, it would apply the practical expedient consistently to all lease contracts with similar characteristics and in similar circumstances. The amendment is to be applied retrospectively in accordance with IAS 8, but lessees are not required to restate prior period figures or to provide the disclosure under paragraph 28(f) of IAS 8.

What is the impact and for whom?

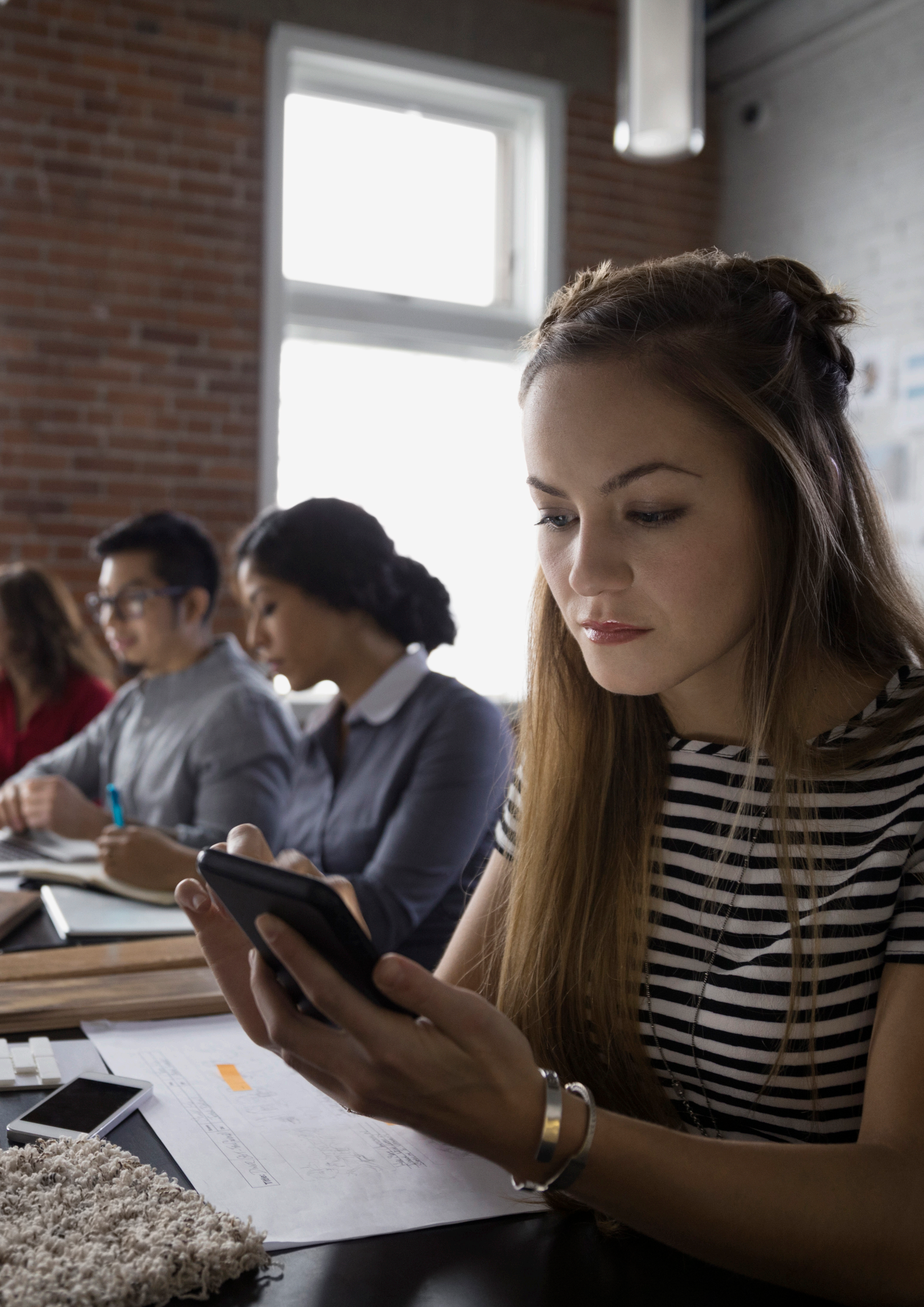
Given the pervasiveness of the pandemic and the measures taken by many governments on social distancing, it is likely that many lessees will have been granted a rent concession of some form, and so these amendments would be applicable. The amendments, however, do not make any changes to lessor accounting.

When does it apply?

The amendments are mandatory for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted, including in interim or year end financial statements not yet authorised for issue at 28 May 2020, to permit application of the relief as soon as possible, subject to any endorsement process.

Where do I get more details?

For more information please contact Jessica Taurae (jessica.taurae@pwc.com).



IASB issues a number of narrow-scope amendments

At a glance

The IASB ('Board') issued a bundle of narrow-scope amendments on 14 May 2020:

- IAS 16: 'Property, Plant and Equipment – Proceeds before Intended Use';
- IAS 37: 'Onerous Contracts – Cost of Fulfilling a Contract';
- IFRS 3: 'Reference to the Conceptual Framework'; and
- Annual Improvements to IFRS Standards 2018–2020 affecting IFRS 1, IFRS 9, IFRS 16 and IAS 41.

All of the amendments are effective 1 January 2022.

What is the issue?

The following is a summary of the amendments:

IAS 16: 'Property, Plant and Equipment (PP&E) – Proceeds before Intended Use'

IAS 16 requires that the cost of an asset includes any costs attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. One of those costs is testing whether the asset is functioning properly.

The amendment to IAS 16 prohibits an entity from deducting from the cost of an item of PP&E any proceeds received from selling items produced while the entity is preparing the asset for its intended use (for example, the proceeds from selling samples produced when testing a machine to see if it is functioning properly). The proceeds from selling such samples, together with the costs of producing them, are now recognised in profit or loss. An entity will use IAS 2, 'Inventories', to measure the cost of those items. Cost will not include depreciation of the asset being tested because it is not ready for its intended use.

The amendment also clarifies that an entity is 'testing whether the asset is functioning properly' when it assesses the technical and physical performance of the asset. The financial performance of the asset is not relevant to this assessment. An asset might therefore be capable of operating as intended by management and subject to depreciation before it has achieved the level of operating performance expected by management.

The amendment requires entities to separately disclose the amounts of proceeds and costs relating to items produced that are not an output of the entity's ordinary activities. An entity should also disclose the line item in the statement of comprehensive income where the proceeds are included.

This amendment could have a significant impact on entities where items are produced and sold as part of bringing an item of PP&E to the location and condition necessary for its intended use, and where management has previously considered an asset's operating performance in its assessment of whether the asset is ready for use (for example, in the mining industry). Management might need to introduce processes to track the cost of items sold and to account for an asset as ready for its intended use earlier than before.

IAS 37: 'Onerous Contracts – Cost of Fulfilling a Contract'

IAS 37 defines an onerous contract as one in which the unavoidable costs of meeting the entity's obligations exceed the economic benefits to be received under that contract. Unavoidable costs are the lower of the net cost of exiting the contract and the costs to fulfil the contract. The amendment clarifies the meaning of 'costs to fulfil a contract'.

The amendment explains that the direct cost of fulfilling a contract comprises:

- the incremental costs of fulfilling that contract (for example, direct labour and materials); and
- an allocation of other costs that relate directly to fulfilling contracts (for example, an allocation of the depreciation charge for an item of PP&E used to fulfil the contract).

The amendment also clarifies that, before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets used in fulfilling the contract, rather than on assets dedicated to that contract.

The amendment could result in the recognition of more onerous contract provisions, because previously some entities only included incremental costs in the costs to fulfil a contract.

IFRS 3: 'Reference to the Conceptual Framework'

The Board has updated IFRS 3, 'Business combinations', to refer to the 2018 Conceptual Framework for Financial Reporting, in order to determine what constitutes an asset or a liability in a business combination. Prior to the amendment, IFRS 3 referred to the 2001 Conceptual Framework for Financial Reporting.

In addition, the Board added a new exception in IFRS 3 for liabilities and contingent liabilities. The exception specifies that, for some types of liabilities and contingent liabilities, an entity applying IFRS 3 should instead refer to IAS 37, 'Provisions, Contingent Liabilities and Contingent Assets', or IFRIC 21, 'Levies', rather than the 2018 Conceptual Framework. Without this new exception, an entity would have recognised some liabilities in a business combination that it would not recognise under IAS 37. Therefore, immediately after the acquisition, the entity would have had to derecognise such liabilities and recognise a gain that did not depict an economic gain.

The Board has also clarified that the acquirer should not recognise contingent assets, as defined in IAS 37, at the acquisition date.

Annual Improvements to IFRS Standards 2018–2020

Fees included in the 10% test for derecognition of financial liabilities

The amendment to IFRS 9 addresses which fees should be included in the 10% test for derecognition of financial liabilities. Costs or fees could be paid to either third parties or the lender. Under the amendment, costs or fees paid to third parties will not be included in the 10% test.

Illustrative examples accompanying IFRS 16, 'Leases'

The Board has amended Illustrative Example 13 that accompanies IFRS 16 to remove the illustration of payments from the lessor relating to leasehold improvements. The reason for the amendment is to remove any potential confusion about the treatment of lease incentives.

Subsidiary as a first-time adopter

IFRS 1 allows an exemption if a subsidiary adopts IFRS at a later date than its parent. The subsidiary can measure its assets and liabilities at the carrying amounts that would be included in its parent's consolidated financial statements, based on the parent's date of transition to IFRS, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary.

The Board has amended IFRS 1 to allow entities that have taken this IFRS 1 exemption to also measure cumulative translation differences using the amounts reported by the parent, based on the parent's date of transition to IFRS. The amendment to IFRS 1 extends the above exemption to cumulative translation differences, in order to reduce costs for first-time adopters. This amendment will also apply to associates and joint ventures that have taken the same IFRS 1 exemption.

Taxation in fair value measurements

The Board has removed the requirement for entities to exclude cash flows for taxation when measuring fair value under IAS 41, 'Agriculture'. This amendment is intended to align with the requirement in the standard to discount cash flows on a post-tax basis.

When do the amendments apply?

All of the amendments are effective 1 January 2022. Earlier application is permitted. The transitional provisions are as follows:

Amendment	Transitional provisions
IAS 16	Applied retrospectively, but only to items of PP&E that are brought to the location and condition necessary for them to be capable of operating in the manner intended by management on or after the beginning of the earliest period presented in the financial statements in which the entity first applies the amendments. The entity should recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of that earliest period presented.
IAS 37	An entity should apply those amendments to contracts for which it has not yet fulfilled all of its obligations at the beginning of the annual reporting period in which it first applies the amendments (the date of initial application). The entity should not restate comparative information. The entity should recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings or other component of equity at the date of initial application.
IFRS 3	Applies to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2022.
IFRS 1	No specific transitional provisions.
IFRS 9	Applies to financial liabilities that are modified or exchanged on or after the beginning of the annual reporting period in which the entity first applies the amendment.
IFRS 16	No specific transitional provisions.
IAS 41	Applies to fair value measurements on or after the beginning of the first annual reporting period beginning on or after 1 January 2022.

Where do I get more details?

For more information please contact Gary Berchowitz (gary.x.berchowitz@pwc.com) or Marie Kling (marie.kling@pwc.com).

Post-model adjustments for expected credit losses during COVID-19

Key considerations in applying post-model adjustments or ‘overlays’ in estimating expected credit losses

At a glance

Banks calculate expected credit losses (‘ECLs’) under IFRS 9 using forward-looking judgements, models and data. Overlays, or post-model adjustments, are often used to address shortcomings where models or data have limitations. As a result of severe economic conditions and uncertainty arising due to coronavirus (COVID-19), there is an increased need to apply overlays in calculating ECLs. In this publication, we provide considerations that might be helpful in developing and monitoring such overlays.

Banks estimating ECLs under IFRS 9 often use a three-step process: 1) develop judgements about the future; 2) apply those judgements to (statistical) models developed based on historical relationships; and 3) use relevant data to feed into the models. This often involves more statistical modelling and data than most other accounting estimates, and it might be very difficult in the current environment. Extreme economic conditions – coupled with uncertainty around the duration of the pandemic, potential for relapses, effects of government support and what recovery will ultimately look like – mean that forward-looking judgements are highly uncertain and challenging to make. At the same time, historical relationships between key variables might no longer hold, and comparable economic conditions might not have existed in the past. Lockdown and social distancing effects and timeframes will need to be expressed in terms of impact on macroeconomic drivers and, ultimately, on default rates. It will not likely be possible to revise models in the short term to capture all of these factors and uncertainties. Banks often use overlays, or post-model adjustments, where risks and uncertainties cannot be adequately reflected in existing models. We expect that such overlays will necessarily play an even more important role and will be higher-level in today’s environment.

What does ‘overlay’ mean?

Overlay’ is a term that can be used to describe a spectrum of adjustments that are made outside the primary models. In some cases, the term can refer to straightforward adjustments in order to correct known model errors or data deficiencies. In others, the overlay is far more subjective and judgemental. For example, it sometimes refers to the application of expert credit judgement to address gaps in models, data or both (for example, as new risks or uncertainties arise). It can also refer to adjustments made to capture risks and uncertainties which are not captured by the models because the models were not designed to address them (such as Brexit). While potentially applicable to all overlays, the considerations in this publication will be of most relevance to overlays towards the more judgemental end of the spectrum.

What questions should banks ask in establishing overlays?

Since they are inherently judgemental, overlays require robust process, governance and internal controls, supported by transparent and high-quality documentation. Key questions to consider include:

- What is the limitation that is being addressed, and why?
- How was the overlay quantified, and what rationale was used?
- What are the underlying assumptions, and how were they developed and supported?
- What data was used, and how was it determined to be appropriate and consistent with similar data used for other purposes?
- How will the overlay be consumed over time (for example, through model development/redevelopment, new data becoming available, or loan-level losses having transpired)?
- How will reasonableness/performance be assessed (for example, by using back-testing, KPI monitoring, comparison to stress-testing and stand-back tests)?

- What has been done to determine, at a sufficiently granular level, the exposures to which the overlay relates?
- How have the staging implications of the overlay been addressed?
- Has an end-to-end review of the ECL modelling process been completed, to ensure that all potential model limitations which might indicate the need for an overlay have been considered? For instance:
  – Is recent borrower information available?
  – Is the data used to calibrate ECL models statistically valid?
  – Are recent forecasts of relevant economic factors available?
  – Are macroeconomic scenarios complete?
  – Are the scenario design and probability weightings appropriate?
  – Has the impact of modifications to existing loans (for example, payment holidays, covenant waivers) been reflected?
  – Are the staging approach and triggers to determine significant increase in credit risk (SICR) appropriate?
  – Are there any other simplifications and, if so, are they appropriate?
  – Have government relief programmes been appropriately taken into consideration?
  – Have events arisen post-model-run that require adjustment?
- Has the overlay been reviewed, together with the end-to-end ECL modelling process, to ensure that there is no potential for double-counting? For instance, taking into account any:
  – top-down adjustments already incorporated by worsening economic forecasts;
  – staging adjustments due to economic expectations already included within PDs;
  – expectations about future losses included in historical data during model calibration; and
  – adjustments to 'days past due' data already included in other top-side adjustments.
- What individuals and committees have provided input or review?

Addressing and documenting these questions helps to ensure adequate processes upfront and to prevent challenges over time as initial limitations (that is, those giving rise to the need for an overlay) are resolved. For instance, among other challenges, the absence of a documented rationale might make it more difficult to determine in future periods whether the overlay is still required.

How do overlays affect disclosures?

Overlays might require additional disclosures, and they might impact others. For interim periods, if there has been a significant change since the most recent year-end in the approach to estimating ECLs (whether due to changes in core models, overlays or otherwise), IAS 34 could require additional disclosures. These could include disclosures about inputs, assumptions and estimation techniques under IFRS 7 and IAS 1. The effect of overlays on disclosures that provide information on a granular basis (for example, disclosures by stage, segment and so on) will need to be thought through in order to determine whether and how the overlay is pushed down, or whether it is (or can be) presented separately. Careful consideration of the disclosure implications of overlays at an early stage might help to 'tell the story' later on and ensure that potential complexities are addressed.

Word on the Wharf

The Board met remotely on 20–21 May 2020.

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

- Amendments to IFRS 17 Insurance Contracts
- Management Commentary
- Research programme update
- Maintenance and consistent application
- IBOR Reform and the Effects on Financial Reporting – Phase 2
- Disclosure Initiative – Accounting Policies

Coronavirus (COVID-19)

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

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