IFRS news

In This Issue

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20 years in the making: IFRS 17 has finally been issued.

Gail Tucker, Global Insurance Accounting Leader, walks through the main elements of the new standards.

IFRS 17 is the biggest shake up of insurance reporting for decades – it has taken 20 years to reach final publication by the IASB. It will impact insurers reporting under IFRS and some other companies, for example banks, who may issue insurance contracts. The aim is to provide more transparency and comparability than the current accounting standard, which grandfathered a myriad of existing accounting policies, even if they were inconsistent within a group.

It is, however, complex and the detail of the standard, together with guidance the IASB issues around implementation, will play a significant role in how the standard is implemented. IFRS 17 will be mandatory for accounting periods beginning on or after 1 January 2021.

Overview of measurement model

IFRS 17 requires a current measurement model where estimates are re-measured each reporting period. Contracts are measured using the building blocks of:

- discounted probability-weighted cash flows;
- an explicit risk adjustment and
- a contractual service margin ('CSM') representing the unearned profit of the contract which is recognised evenly

The standard allows a choice between recognising changes in discount rates either in the income statement or directly in other comprehensive income. The choice is likely to reflect how insurers account for their financial assets under IFRS 9. Many insurers will take advantage of the option to defer implementation of IFRS 9 until they adopt IFRS 17.

An optional, simplified premium allocation approach is permitted for the liability for the remaining coverage for short duration contracts, which are often written by non-life insurers.

There is a modification of the general measurement model called the 'variable fee approach' for certain contracts written by

life insurers where policyholders share in the returns from underlying assets. The modification allows certain changes to be recognised against the CSM and the results of insurers using this model are therefore likely to be less volatile than under the general model.

Key changes from current accounting

The new standard is likely to have a more significant impact on many life insurers, given the long term contracts they write. However, non-life insurers will also see changes in the accounting for reinsurance and they will be required to discount claims.

Some of the key changes from today's accounting will be:

- All cash flows will be based on current assumptions whereas for some insurance contracts today (often written overseas) insurance is measured using historic assumptions.
- Revenue will be more consistent with IFRS 15, excluding deposit components, and will not be recognised on a cash basis as is currently the case for life insurers.
- The measurement will require historic data, such as discount rates and unearned profit; data has not been captured for current accounting and regulatory reporting.
- The calculation will be at a lower level of granularity than many insurers use today.

Impact

IFRS 17 will impact businesses well beyond the finance, actuarial and systems development areas. For example, it could affect product design and distribution, incentive plans and wider remuneration policies, and budgeting. There could also be an impact on the cash tax position and dividends, depending on local regulation.

The introduction of IFRS 17 will be a significant challenge for many insurers. This is viewed as the price of improved accounting practices and comparability. Many hope that better accounting practices will improve how investors see the industry and will reduce the cost of capital for the industry in the future.

What should insurers be doing now?

- Educate staff and boards to raise awareness
- Undertake impact assessments (both financial and operational)
- Plan the IFRS 17 project to secure budgets and resources
- Consider the interaction of IFRS 17 with ongoing or planned projects, such as finance transformation work

Available in iTunes and pwc.com/ifrs
PwC IFRS Talks

The Leases Lab

IFRS 16 brings significant changes to accounting for lessees, but what about lessors? Can Professor Lee Singh and his assistant Derek Carmichael help you separate the truth from the fiction? Let's experiment!

Hypothesis

Accounting for lessors under IFRS 16 is nearly the same as under IAS 17, therefore they do not need to think about the impact of the new standard.

Testing and analysis

IFRS 16 does not contain substantial changes to lessor accounting compared to IAS 17. The lessor still has to classify leases as either finance or operating, depending on whether substantially all of the risk and rewards incidental to ownership of the underlying asset have been transferred.

The indicators the lessor uses to make this distinction are the same as under IAS 17. For example, the lessor still compares the lease term with the economic life of the underlying asset, and the present value of the lease payments with the fair value of the leased asset.

> For a **finance lease**, the lessor recognises a receivable at an amount equal to the net investment in the lease which is the present value of the aggregate of lease payments receivable by the lessor and any unguaranteed residual value.
>
> For an **operating lease**, the lessor continues to present the underlying asset.

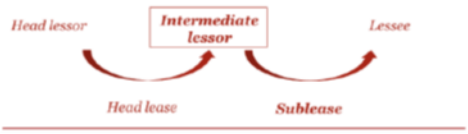
Changes for lessors?

Although the mechanics of how leases are accounted for remain unchanged, a number of topics do affect both lessee and lessor.

First, there is the revised guidance in IFRS 16 on the definition of a lease.

Second, 'lease term' and 'lease payments' are defined for both lessees and lessors in the same way, for example, whether or not extension or termination options are taken into account when determining the lease term, or variable lease payments are included also affects the lessor.

Other areas that impact the lessor are the requirements for separation of components of a contract and combining contracts. (see our April 2017 article).



Sub-leases

Intermediate lessors must now classify subleases based on the right-of-use asset from the head lease, rather than the underlying lease asset (as under IAS 17).

For example, the term of a sub-lease would be compared to the term of the head lease when assessing whether the lease is for the major part of the economic life.

Similarly, the present value of lease payments is compared to the fair value of the right-of-use asset, instead of the underlying asset when assessing whether it is for substantially all of the fair value.

As the head lease term and fair value of a right-of-use asset is normally smaller than the life or fair value of the underlying asset, it is now more likely that a sublease will be classified as a finance lease.

Practical Impact

Lessors should also consider how changes in lessee accounting might impact them. Changes in lessee needs and behaviours might require lessors to enter into different agreements with their customers.

As lessees must recognise a right-of-use asset and a lease liability for almost every lease, they may want to minimise the liability recognised on their balance sheets.

The focus in negotiations might no longer be on whether the contract would qualify as an operating or a finance lease but instead on whether the definition of a lease is met at all.

Other negotiation points might include variable lease payments which could be excluded from the lease liability, or inclusion of termination options which might minimise the lease term.

Conclusion

IFRS 16 does contain changes which might have an accounting impact on lessors, but the commercial impact might be even more important.

For more on lessor accounting, see our In depth, IFRS 16 – A new era of lease accounting. You might also find our range of videos helpful.

Scene 3, Take 1: Demystifying IFRS 9 for Corporates: Good news for financial liabilities

Nitassha Somai, Financial Instruments expert, works through one of the biggest impacts of IFRS 9 on corporates

LIGHTS, CAMERA, ACTION!

Dear Corporate,

We have good news for financial liabilities. IFRS 9 does not change much of today's accounting. For items such as borrowings, trade payables and intra-group liabilities, the accounting will remain the same.

My top three key reminders for financial liabilities are:

- Classification as a financial liability or equity is not covered in IFRS 9. IAS 32, *Financial instruments: Presentation* covers this.
- There are two categories of financial liabilities: amortised cost or fair value through profit or loss (FVTPL). Current classification is not expected to change under IFRS 9.
- Financial liabilities still need to be assessed for embedded derivatives, such as prepayment options.

What should corporates be looking out for?

Financial liabilities could be impacted by IFRS 9 if:

- borrowings were restructured in the past, and
- the resulting gain or loss on modification was spread forward rather than recognised in profit or loss (P/L) on modification date.

What does this mean?

A modification is a renegotiation of the original terms of a loan agreement, but the changes to the terms are not significant enough to result in either extinguishment or a substantial modification. In March 2017, the Board tentatively decided that under IFRS 9, the difference that arises at the modification date from updating the carrying value to reflect the new terms needs to be recognised immediately in P/L.

The gain or loss is calculated as the difference between the original cash flows and the modified cash flows, discounted at the original effective interest rate.

This change could be significant for corporates because today most corporates spread the gain or loss forward rather than recognising it in P/L immediately.

What does this mean for your accounting today?

It is not expected that your existing policy under IAS 39, *Financial instruments: Recognition and Measurement* has to be changed. There could, however, be an impact when you transition to IFRS 9. IFRS 9 requires retrospective application on transition. Any unrecognised gains or losses on the transition date will need to be adjusted against opening retained earnings.

Company A (YE – 31/12/2018) modified the terms of a borrowing on 1 January 2017. The modification is not an extinguishment or substantial modification.

A gain of CU100 arose on modification. Under IAS 39 Company A decided to spread the gain over 10 years (the remaining term of the borrowing) by releasing CU10 to P/L every year.

On transition to IFRS 9, Company A will no longer be able to spread the remaining CU90 gain. Instead, the remaining unamortised gain of CU90 will be adjusted against opening retained earnings on 1/01/2018.

This change will only impact borrowings recognised in the balance sheet on date of initial application of IFRS 9.

Conclusion

Reminders from Scene 3, take 1 for financial liabilities are:

- Classification as amortised cost or FVTPL is expected to remain unchanged.
- Embedded derivatives still need to be assessed for separation.
- Modification gains/losses on renegotiated financial liabilities which do not qualify for derecognition should be recognised in P/L immediately.

CUT!!!

Our full range of IFRS 9 content and videos can be found here

IFRIC Rejections Supplement-IAS 36

Paul Shepherd of Accounting Consulting Services examines the practical implications of IFRIC rejections (NIFRICs) related to IAS 36.

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 34 as per below.

IAS 36 covers impairment of non-financial assets. The standard has a number of practical application challenges, for example, the requirement to use pre-tax discount rates in a Value in Use. However, despite these challenges there have only been five rejections.

The Board has started a project to consider the future of the impairment standard as part of the post implementation review of IFRS 3.

Retail store CGU's - March 2007.

Testing for impairment starts with individual assets and then considers when those assets should be grouped to form a larger cash generating unit (CGU). The IC was asked whether retail stores could be grouped in to a CGU containing multiple stores.

The IC concluded the existing literature was clear and that testing was focused on assets that generated independent cash inflows, that is, stores. Shared outflows and infrastructure like marketing spend and distribution centres are not part of the assessment and, as such, each retail store is a separate CGU.

Ten years on, the retail sector has evolved considerably; online ordering with in-store pick-up, home delivery and collection centres have been added to bricks and mortar. These changes provide new impairment challenges such as what group of assets generate independent cash flows and are their own CGU.

The recoverable amount of a CGU and liabilities - May 2016

The most recent NIFRIC looks at the impairment test when an entity needs to consider a recognised liability to determine the recoverable amount of a CGU. For example, when a buyer would have to assume the liability, such as a restoration obligation of a mine. The NIFRIC confirms that the carrying amount of the liability must be deducted from the carrying amount of the CGU and from the measurement of Value in use (VIU), rather than including the actual cash flows (amount and timing) in the VIU.

The CGU carrying amount and the VIU measured in this way would be compared with the Fair value less cost of disposal (FVLCD) of the CGU when assessing impairment.

This topic was discussed in more detail in our PwC In brief.

Summary of NIFRICs for IAS 36:

Topic	Summary conclusion
The recoverable amount of a CGU and liabilities - May 2016	The IC was asked about the treatment of a liability which is included in an impairment calculation as it would be considered in the recoverable amount. The IC confirmed the carrying amount of the liability should be deducted from both the value in use calculation and the carrying amount of the CGU.
Testing investments in Associates for impairment in Separate Financial Statements (SFS) - January 2013.	The IC confirmed that in SFS an entity should apply IAS36 to test investments in Subsidiaries, Associates and Joint Venture that are carried at cost under IAS 27.
Calculating Value in Use (VIU) using Dividend Discount Models (DDM) - November 2010.	VIU tests typically use a discounted cash flow (DCF) model, with specific rules on what can be included when testing for impairment. The IC confirmed that using a DDM was possible when testing an investment in shares as long as the model was consistent with the principles of IAS 36.
Retail store CGU's - March 2007.	The IC confirmed an individual retail store would be a CGU and this should not be stored with other retail stores.

PwC revenue specialists investigate how to account for warranties under IFRS 15

The IFRS 15 Mole

Suspects

Warranties – are they distinct?

Incident description

Sellers often provide customers with warranties, a type of guarantee that the seller will replace or repair a product that becomes defective within a particular time period. The nature and terms of such agreements vary across entities, industries, products and/or contracts.

Entities that provide warranties will need to determine whether those warranties are separate performance obligations or not.

A warranty that can be purchased separately from the related product will generally be a separate performance obligation. This is because the customer is able to buy the separate service, being the 'insurance' of the product, and that service is separable. Revenue should be allocated to the warranty and recognised over the warranty period in this situation.

A warranty that cannot be purchased separately from the product requires more investigation. The seller should assess whether the warranty provides assurance (for example, safeguarding the customer

...with the help of the Mole.

against existing defects in the product, but no incremental service to the customer) or a service in addition to assurance (for example, a level of protection beyond defects that existed at the time of sale).

A warranty that only provides assurance against defects that exist at the time of sale are not separate performance obligations. Therefore, any estimated costs to either repair or replace the product are additional costs of providing the initial product and are recorded as a liability in accordance with IAS 37. This liability is recognised when the entity transfers the product to the customer.

A warranty that provides a service in addition to assurance (similar to those acquired separately) should be accounted for as a separate performance obligation, and revenue allocated to that performance obligation.

Facts

An Entity enters into a contract with a customer to sell a smart phone and provide a one-year warranty for both manufacturing defects and customer-inflicted damages (for example, dropping the phone into water). The warranty cannot be purchased separately.

The Entity will account for the warranty for manufacturing defect in accordance with IAS 37, recording an expense and liability for expected repair or replacement costs related to this obligation based on historic data. The warranty for customer-inflicted damages are for incremental service to the customer covering damages which occur after sale. The customer-inflicted warranty will be accounted for as a separate performance obligation, with revenue recognised over the warranty period.

If the entity cannot reasonably separate the two warranties, it should account for them as a single performance obligation.

Recommendations

Entities should consider the following factors when assessing whether a warranty, that is not sold separately, provides a service that should be accounted for as a separate performance obligation:

Further investigations

If a warranty is identified as a separate performance obligation, the entity will have to allocate part of the transaction price in accordance with step 4 in the IFRS 15 5 step-model.

Factors	Separate PO?
Warranty is required by law	A legal requirement indicates that the promised warranty is not a performance obligation. Such requirements typically exist to protect customers from the risk of purchasing defective products.
Length of warranty period	The longer the coverage period, the more likely it is that the warranty is a performance obligation.
Nature of tasks - entity promises to perform	If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), such tasks are unlikely to give rise to a performance obligation.

Cannon Street Press

Editors choice

IFRIC Interpretation Ratification

The Board ratified IFRIC Interpretation Uncertainty over Income Tax Treatments and expects to issue the Interpretation in the second quarter of 2017. The Interpretation addresses various issues relating to uncertain tax treatments.

Other Highlights

IFRS Maintenance

Amendments to IAS 28 — Long-term interests in associates and joint ventures

The Board tentatively decided to finalise the proposed amendments to IAS 28 Investments in Associates and Joint Ventures. The amendments clarify that IFRS 9 *Financial Instruments* applies to long-term interests in associates or joint ventures. Long-term interests are interests that in substance form part of the net investment but are not accounted for using equity accounting.

The Board tentatively decided also to clarify in IAS 28 that:

a) the IFRS 9 requirements are applied to long term interests before applying the loss allocation and impairment requirements of IAS 28.

b) the entity should not take account of any adjustments to the carrying amount of long-term interests that result from the application of IAS 28, when applying the IFRS 9 requirements.

The Board tentatively decided to develop educational material to illustrate the interaction between IAS 28 and IFRS 9 in relation to long term interests.

The Board tentatively decided to set an effective date of 1 January 2019 with earlier application permitted. Retrospective application would be required in accordance with IAS 8. Transition requirements for entities that apply the amendments after they first apply IFRS 9 would be similar to those in IFRS 9 regarding classification and measurement.

Research Projects

Research projects

Goodwill and Impairment

The Board discussed possible simplification of the impairment model for goodwill and whether it should become a single measure model (being Value in Use or fair value) or whether the current 'higher of the two' model represents the best measure. Various views were discussed. No decisions were made.

These are the editor's top picks from the May Board meeting. For a comprehensive list of all discussions visit the IASB website www.IFRS.org

The bit at the back ...

For further help on IFRS technical issues, contact:

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

Financial instruments
Kyriaki Plastira: Tel: +30 210 687 4425
kyriaki.plastira@gr.pwc.com

Liabilities, revenue recognition and other areas
Vart Kassapis: Tel: +30 210 687 4757
vart.kassapis@gr.pwc.com

Business combinations

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

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