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Must know

Disclosure of the expected impact of IFRS 16

At a glance

IFRS 16, the new accounting standard for leases, becomes effective for annual reporting periods commencing on or after 1 January 2019. As with other new accounting standards, IFRS reporters are required to disclose information relevant to assessing the impact of IFRS 16 in periods prior to adoption.

The 2018 annual reporting period is the final reporting period prior to the mandatory adoption of IFRS 16; and, by the time that companies publish their 2018 annual reports, they will have implemented IFRS 16.

The European Securities and Markets Authority (ESMA) has published guidance setting out its expectations of disclosure of the impact of IFRS 16 within 2018 annual reports. This In brief summarises the IFRS requirements and expectations of ESMA, and it sets out our practical suggestions of matters for entities to consider disclosing.

What is the issue?

Regulator focus on robust disclosure of the expected impact of IFRS 16

Paragraphs 30 and 31 of IAS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', detail the disclosure requirements for the expected impact of new accounting standards which have not yet been adopted. In particular, IAS 8 requires entities to disclose known or reasonably estimable information relevant to assessing the possible impact that application of IFRS 16 will have on an entity's financial statements in the period of initial application.

There has been recent regulator focus on providing robust disclosure of the impact of IFRS 16 within 2018 annual reports. ESMA stated its expectations of this disclosure in its 26 October 2018 Public Statement of European Common Enforcement Priorities for 2018 Annual Reports.

In particular, ESMA notes that, because the 2018 annual report will be published after the requirements in IFRS 16 become effective, it expects that issuers will have substantially completed their IFRS 16 implementation by the time that the 2018 annual report is issued. ESMA clearly stated that it expects that the impact of IFRS 16 should be known or reasonably estimable at the time of preparing the 2018 annual report, and so this impact should be disclosed.

It is therefore important that entities carefully consider the expected impact of IFRS 16, to provide specific and meaningful disclosure.

What is the impact and for whom?

Practical suggestions for robust disclosure of the impact of IFRS 16

All entities with leases, or arrangements where significant judgement has been made in assessing whether it contains a lease, will need to consider their disclosure of the expected impact of IFRS 16. Entities without leases should consider disclosing the fact that IFRS 16 is not expected to impact them.

With reference to the requirements of IAS 8, and the expectations of ESMA, we set out below our practical suggestions of matters for entities to consider disclosing in relation to the expected impact of IFRS 16:

NB: these practical suggestions are solely an indicative guide of how an entity could respond to the need to disclose the impact of IFRS 16. Disclosures should be entity-specific, and each entity should consider what disclosures best meet the requirements of IAS 8 and regulator expectations, based on their specific facts and circumstances.

- Disclose the fact that IFRS 16: *Leases* has not yet been applied, that it is applicable for annual reporting periods commencing 1 January 2019, and the date on which the entity expects to first apply IFRS 16.
- Information about the structure and status of the entity's implementation project.
- A description of the changes in accounting policy which will take effect, including whether exemptions will be applied (such as low-value or short-term exemptions).
- A description of which transition approach will be taken, and whether any practical expedients will be applied.
- A description of the key judgements and estimates made (such as assessing whether an arrangement contains a lease, determining the lease term, calculating the discount rate and whether any service/lease components of arrangements will be separated), and identifying lease portfolios for which IFRS 16 has a significant impact.
- Quantification of the expected impact (restatement to assets, liabilities and retained earnings/opening retained earnings adjustment, or the change in assets, liabilities, income, expense on adoption, depending on transition approach).
- If alternative performance measures (APMs) are used by investors (such as EBITDA), and IFRS 16 is expected to have a significant impact on those APMs, the quantum of that impact (considering ESMA guidance on the use and disclosure of APMs).
- If taking the simplified transition approach, an explanation of any differences between the current operating lease commitment disclosure and IFRS 16 lease liability balances, and a statement that lease liability comparative information has not been restated.

When does it apply?

IFRS 16 applies for annual reporting periods beginning on or after 1 January 2019. Therefore there is an expectation, as explained above, that disclosures within the 2018 annual reports will sufficiently explain the expected impact of IFRS 16, particularly given that 2018 annual reports will be released during 2019, after IFRS 16 has been adopted.

Accounting considerations for Venezuelan entities (update as of November 2018)

This In brief supersedes In brief INT2018-09, 'Accounting considerations for Venezuelan entities (update as of April 2018)'.

Background

In recent years, the Venezuelan government has maintained a regime of strict currency controls. Multinational companies continue to face significant difficulties in repatriating earnings from Venezuelan entities. There is significant uncertainty about exchange rates, the amount that can be repatriated at a given exchange rate, and the timing of repatriation. The Venezuelan economy continues to exhibit high inflation. There is also a continuing high level of government regulation (that is, price regulation and labour law), which might limit the decision-making powers of management.

During 2017, two currency exchange mechanisms were in place, namely the DIPRO and DICOM mechanisms.

At the end of January 2018, and with the aim of establishing a unified system, the Venezuelan government:

- relaunched the DICOM mechanism, which applies to all foreign exchange transactions from 26 January 2018; and
- eliminated the DIPRO mechanism, which was used previously for imports of goods and services identified as critical or priority.

In August 2018, the Venezuelan government announced a monetary reconversion, which created a new currency, the Sovereign Bolivar (VES), that replaces gradually from 20 August 2018 the previous currency (VEF) at a conversion rate of VES 1 to VEF 100,000. Entities need to adapt their systems and processes to the new currency.

In September 2018, the government also introduced certain changes to the currency exchange system. The new exchange system would introduce the possibility for financial institutions to exchange foreign currency, which is in practice exchanged at a single rate regulated by the Venezuelan Central Bank (VCB). However, the relevant regulator has not yet issued the rules and regulations that would enable the application of the new exchange system. Therefore, DICOM continues to operate.

Exchange rates in Venezuela

The DICOM exchange system is a single legal exchange rate that is published by the VCB.

The auctions on the DICOM mechanism held in 2018 (up to the date of this publication) resulted in an exchange rate that fluctuated between VEF 25,000/USD 1 (equivalent to VES 0.25/USD 1) on 5 February 2018 and VES 77.21/USD 1 on 22 November 2018. Volumes on these auctions have been very low throughout the year, but they have started to increase in recent months due to the significant devaluation of the currency.

Measuring assets and liabilities denominated in foreign currency

IAS 21 requires the use of closing rates. In determining whether a rate is a closing rate, an entity should consider whether currency is obtainable at an official quoted rate and whether the quoted rate is available for immediate delivery. In practice, a normal administrative delay in obtaining funds would be acceptable.

Where exchangeability between two currencies is temporarily unavailable at a transaction date or a subsequent balance sheet date, paragraph 26 of IAS 21 requires entities to use the rate on the first subsequent date at which exchanges could be made.

The DICOM exchange rate published by the VCB can be considered a spot rate, and it can be used to translate monetary assets and liabilities. However, each entity will need to determine, considering their specific circumstances, whether the official exchange rate meets the definition of a closing rate (see below for further references to the IFRS IC agenda decision issued in September 2018).

Entities should disclose the rate used and the effect on the amounts reported in the financial statements. Any significant accounting policies and judgements made in determining the rate should be disclosed in accordance with the requirements in paragraphs 117 to 124 of IAS 1, 'Presentation of financial statements'. Management should also consider disclosing the sensitivity of using a different exchange rate in accordance with paragraph 129 of IAS 1, as part of the disclosures of sources of estimation uncertainties (required by paras 125 to 133 of IAS 1).

Net assets of a subsidiary in Venezuela

Parent companies typically use the dividend remittance rate to translate the net assets of a foreign operation, because this is usually the rate that would apply if funds from the foreign operation were remitted to the parent at the reporting date.

Management should consider the particular circumstances (including, where relevant, the views of the relevant regulator), and might also consider taking legal advice over the rate that will be available for the payment of dividends. Management should also consider the IFRS IC agenda decision issued in September 2018 addressing the determination of the exchange rate in the extreme circumstances that currently exist in Venezuela. The circumstances described in the agenda decision consider situations where: the exchangeability of the currency is administered by exchange mechanisms, and the authorities set the exchange rates; and the currency is subject to a long-term lack of exchangeability, which results in an entity being unable to access foreign currencies using the exchange systems in place.

The IC concluded that, in the situations described, entities need to determine if the official exchange rate or rates meet the definition of the closing rate (which is the spot exchange rate at the end of the reporting period).

Since economic conditions change frequently in Venezuela, the IC also observed that entities need to reassess, at each period end, any relevant changes in circumstances.

The rate used in translation, and the impact of that rate, should be disclosed. Any significant accounting policies and judgements made in determining the rate should be disclosed in accordance with the requirements in paragraphs 117 to 124 of IAS 1. Management should also consider disclosing the sensitivity of using a different exchange rate in accordance with paragraph 129 of IAS 1, as part of the disclosures of sources of estimation uncertainties (required by paras 125 to 133 of IAS 1). The IC agenda decision referred to these disclosure requirements, and also observed that any significant restrictions on the ability to access or use assets and settle liabilities of operations in Venezuela should be disclosed in accordance with paragraphs 20 and 22 of IFRS 12.

Consolidation of Venezuelan subsidiaries

Some have questioned whether continuing uncertainty and difficulties in repatriation mean that multinational companies should consider de-consolidation of their Venezuelan subsidiaries under IFRS.

Multinational companies should only de-consolidate Venezuelan subsidiaries if they no longer meet the three criteria for control under IFRS 10, 'Consolidated financial statements'. Uncertainty about repatriation of profits and exchange restrictions alone are unlikely to result in a loss of control under IFRS 10. However, each situation should be addressed on its individual merits.

An investor controls an investee if it has all of the following elements:

power over the investee;

exposure, or rights, to variable returns from its involvement with the investee; and

the ability to use its power over the investee to affect the amount of the investor's returns.

[IFRS 10 para 7(a)–(c)].

If one or more of the elements of control changes, an entity should reassess control.

An investor will lose control of its subsidiary when it no longer has the power to direct its relevant activities, and hence loses the ability to vary its returns. This is a high hurdle. Where an entity has power, it must demonstrate (in order to determine that it does not have control) that it has no exposure to variable returns. Difficulties in repatriating earnings, and uncertainty about the exchange rate, are not the same as a loss of control.

This follows from paragraph B83 of IFRS 10, which states, *"An investor that has power over an investee can lose control of an investee if the investor ceases to be entitled to receive returns or to be exposed to obligations"*.

A parent that continues to direct the relevant activities of its investee in Venezuela meets the power criterion, and it is likely to remain exposed to the variable returns. Those returns could be positive or negative, and they are not only financial in nature (see paras B56 and B57 of IFRS 10).

Different multinational parents might find themselves in different circumstances, and each fact pattern should be carefully considered. However, we believe that most multinational parents with subsidiaries in Venezuela will continue to consolidate in the current environment.

A parent needs to consider whether there is significant doubt about the existence of control.

An entity should also consider what should be disclosed to explain the significant judgements and assumptions made in its control assessment. [IFRS 12 para 7]. An entity is also required to disclose significant restrictions on its ability to access or use the assets and settle the liabilities of the group. [IFRS 12 para 13].

Hyper-inflation, estimation of the general price index and impairment considerations

Venezuela is a hyper-inflationary economy, and IAS 29, 'Financial reporting in hyper-inflationary economies', should be applied. Please refer to In brief INT2018-01 'Hyper-inflationary economies at 31 December 2017' for a list of hyper-inflationary economies at 31 December 2017.

The application of IAS 29 requires the use of a 'general price index that reflects changes in purchasing power'. The official body responsible for publishing inflation rates in Venezuela is the VCB. However, no official indices have been published by the VCB since December 2015.

IAS 29 considers circumstances in which a general price index might not be available, and it suggests that the inflation rate can be estimated based on the devaluation of the hyper-inflationary currency against a relatively stable foreign currency. However, due to the strict currency controls in place in Venezuela, the devaluation of the currency has not depicted inflation rates and therefore is not used as an alternative to estimate inflation.

In these circumstances, judgement will be required to estimate a general price index. That could be done, for example, by using external experts to estimate inflation. Alternatively, entities could estimate inflation internally and validate the estimates by reference to the ranges estimated by experts and any other publicly available information, such as financial reports, or other economic information provided by official sources, etc.

The level of the price index used and its impact should be disclosed in accordance with paragraph 39 of IAS 29. Any significant accounting policies and judgements made in determining the inflation rate should be disclosed in accordance with the requirements in paragraphs 117 to 124 of IAS 1. Management should also consider disclosing the sensitivity of using a different inflation rate in accordance with paragraph 129 of IAS 1, as part of the disclosures of sources of estimation uncertainties (required by paras 125 to 133 of IAS 1).

Finally, taking into consideration the significantly high levels of inflation that exist in Venezuela, entities should bear in mind that non-monetary assets that have been restated following the guidance in IAS 29 are still subject to impairment assessment in accordance with the relevant guidance. If an asset's recoverable amount is less than its restated amount, the asset is written down, even if no impairment of the asset was required in the historical cost financial statements. Any impairment charge is recognised in profit or loss.

Cash balances

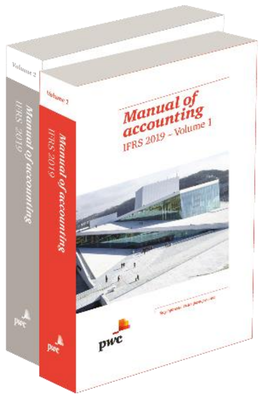
Management should also consider disclosing, under IAS 7, 'Statement of cash flows', the effect of the exchange controls in Venezuela on whether cash balances are available for general use by the group.

Word on the Wharf?

The November 2018 IASB update has been published and the work plan updated.

The topics, in order of discussion, were:

- IFRS 17 Insurance Contracts
- Primary Financial Statements
- IFRS Implementation Issues
- Management Commentary
- Classification of liabilities as current or non-current (Amendments to IAS 1)
- Updating a reference to the Conceptual Framework (Amendments to IFRS 3)
- Rate-regulated Activities



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  -Long term interests in associates and joint ventures
- Revised conceptual framework issued in March 2018

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