IFRS news

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New year's resolutions every company should take on board

Elana Du Plessis, PwC Senior Manager, shares the new year's resolutions all companies should consider.

It's that time of year again - everyone is frantically making resolutions in the hope that the statement 'New Year, New Me' will finally be true. Statistically only about 9% of people feel that they are successful at keeping their resolutions. We share some resolutions that companies could be making - and keeping - to improve their reporting in 2017.

1. Lose weight

The IASB announced *Better communication* as their central theme looking to 2021. This is part of a continued drive to 'cut the clutter' in financial statements. Many companies might consider if they stand to 'lose some financial statement weight.' Focusing on material information is a great place to start when trying to cut clutter. A different format may also be a good way to cut out unnecessary information. Our Illustrative IFRS consolidated financial statements for 2016 year ends has some ideas of how to achieve this.

2. Get out of debt

Financial debt is always a top priority for companies, but can be an area where reporting comes up short. The IASB issued an amendment to IAS 7 *Statement of cash flows* in 2016 to help investors better understand changes in an entity's debt. The amendment requires disclosure of changes in liabilities arising from financing activities, including cash flows (such as drawdowns and repayments of borrowings), and non-cash changes (such as acquisitions, disposals and unrealised exchange differences).

The amendment is effective from 1 January 2017, but early application is permitted. More detail on the requirements in this In brief.

3. Learning something new

The wait for new standards is almost over. The effective date of IFRS 15 *Revenue from contracts with customers* and IFRS 9 *Financial instruments* is 1 January 2018; many companies have already started the comparative period for applying these standards. Even with transition relief there is no time to waste with regards to implementation. It is especially important to start preparing disclosures early on. Find some helpful hints in our New IFRS for 2016 publication.

4. Spend more time with family and friends

Engaging with stakeholders is a key part of the reporting process. Knowing the audience for reporting is essential for deciding how best to communicate transactions and events that occurred throughout the year. Spending time actively engaging with investors could help identify material issues, areas of focus and improvement, and investors' overall impression of the quality of management. See more thoughts on what investors want in our 2016 Investor survey.

5. Commitment

Keep your resolutions and enjoy a year of successful reporting.

Demystifying IFRS 9 Expected credit loss model

Incorporating forward looking information is a big change under IFRS 9. Nitassha Somai, Financial instruments specialist, looks into her crystal ball to make some predictions!

The IFRS 9 expected credit loss (ECL) model requires entities to look beyond past and current events to calculate credit loss. The requirement to include future macro-economic events is a significant change under the new model. This might conjure up an image of a crystal ball: Are accountants the next generation of fortune tellers?
Let's find out as we explore one of the trickiest and most fundamental areas of the ECL model: forward looking information.

What is meant by reasonable and supportable information?

Management must consider all available information that is reasonable and supportable without undue cost or effort. A bank, particularly larger ones, will not be able to credibly assert "undue cost or effort". Credit risk management is their core activity.
Reasonable economic scenarios, including one off events (such as Brexit) should be taken into account. For example, if an economic downturn results in unemployment, it is expected that this should be taken into account when determining recoverability of a retail portfolio.

Information cannot be excluded because it has a low probability of happening or is remote. Highly speculative scenarios with little or no basis are not expected to be taken into account. The risk of excluding low probability events should be balanced against including highly speculative events with little or no basis and should be appropriately documented by management.

How many scenarios to include?

The number of scenarios is not specified and will depend on a number of factors such as the type of financial asset, industry and the economic environment. Management is required to take into account a range of scenarios (as it is an unbiased calculation) and consider non-linearity. Non-linearity means that the percentage change to a macroeconomic scenario might not be proportional to the change in credit loss. For example a 10% increase in unemployment, might double or even quadruple credit loss. The range of scenarios and non-linearity should be reassessed continuously to ensure the model appropriately reflects any changes. Assessments should be revisited at every reporting date.
We see many banks, in practice, using three scenarios and looking forward three to five years. Forecasts 5 years out are viewed as less reliable.

How to take it into account?

Forward looking information can either be provided for in the credit model (by adjusting the probability of default) or as a management overlay. There is no one right answer and the method adopted might differ between entities and for different financial assets. Most entities, in practice, prefer making adjustments to the credit model.

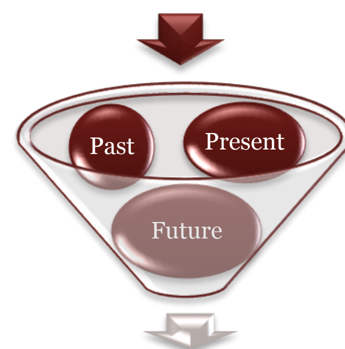
Management should ensure there is consistency in the way forward looking information is incorporated and that it is not double counted. Don't adjust the credit model and also provide a management overlay.

Conclusion

What can we predict with our crystal ball:

- Banks will incorporate forward looking scenarios into considering both ECL and significant increase in credit risk.
- Determining the number of reasonable and supportable scenarios and how to incorporate them is a tricky and highly judgmental area. Transition will be a major challenge as management lacks the necessary data and models to incorporate this information.
- Sufficient disclosure of management judgment should be made to help users understand the impact of forward looking information on ECL, including those rare occasions when it is not possible to incorporate the impact of one-off forward looking events in ECL.
- For more information see Demystifying IFRS 9 - 4: Forward looking information

All reasonable and supportable information without undue cost or effort.



Impacts
- ***ECL***
- ***Significant increase in credit risk***

The Five Stages of Grief - Accepting IFRS 17, Insurance

Irina Sedelnikova, PwC Insurance specialist, explains how to work towards accepting IFRS 17

Psychologist Elisabeth Kübler-Ross discovered that people go through five stages of grief: denial, anger, bargaining, depression, and acceptance. As the new Insurance Standard, IFRS 17, looms, what stage are you in?

1

Stage 1 - Denial

The majority of people affected by IFRS 17 are still in denial. *'The IASB have been developing the Standard for 20 years now, it will never go live'*. Many do not believe the standard will ever be finalised given we celebrated the 20th birthday of the project in 2017. The IASB have recognised this and prioritised the finalisation of IFRS 17 over other projects. The IASB Chairman, Hans Hoogervorst, is focused on completing the gap in the Board's suite of accounting standards.

2

Stage 2 –Anger

'The Standard/IASB's decisions are fatally flawed!' Some major industry players believe that the Standard is not ready. They believe that applying IFRS 17 to financial statements will not reflect the economics of their operations. The IASB have discussed the industry's concerns numerous times and IFRS 17 is their response to ensure consistency with other standards.

3

Stage 3 - Bargaining

Some people and organisations have moved to the bargaining phase. This is indicated by following:

1. Why can't I have one unit of account for a mutualized fund? By the way, contracts in a portfolio also cross-subsidise even when there is no contractual mutualisation. This is the nature of the insurance business!
2. Indirect participating contracts should be in the scope of the variable fee approach. The economics of such contracts are no different to direct participating contracts, even though the contractual terms are different.
3. Of course I can use premium allocation approach for all of my general insurance portfolios, it is largely the same accounting as I do today. Later (after 2021) I could develop systems and processes to smoothly move to the building block approach.

4

Stage 4 - Depression

Some who have been there from the start have now reached IFRS 17 depression. '*It is going to be very hard*' they sadly say about implementation.

5

Stage 5 - Acceptance

Very few people have made it to the IFRS 17 acceptance phase. However, those who have made it believe that the insurance industry does not benefit from the current state of affairs and a change is needed. IFRS 17 gives companies the opportunity to explain to investors how the industry operates and how they compare to each other and to companies in other industries.

Top tips to survival

To survive the IFRS 17 implementation years with minimum harm, here are our top tips:

- *Consolidate efforts*. This will be a massive change for the majority of players. This will be the most actuarial standard in the history of IFRS (no surprises, right? It's insurance!). Accountants will not be able to make it alone; engage actuaries and IT developers in the early stages so they understand what is needed.
- *Make sure your top management is aware of the coming storm*. No matter whether you make it on your own or involve consultants, this will require significant time and resources. Start talking to your big bosses to avoid huge surprises (they generally do not like these) and get their support and commitment.
- *Don't wait*. At the November meeting the IASB members were in absolute agreement that implementation will require at least three and a half years. Unless you retire or change employer and industry before 2021, there are no excuses.

IFRIC Rejections in short – IAS 28

Joanna Demetriou of Accounting Consulting Services examines the practical implications of IFRIC rejections related to IAS 28.

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 28 as per below.

Five matters related to IAS 28 have resulted in an agenda rejection by the IC to date, one of which has been deferred to the Business Combinations under common control project.

The latest tentative agenda decisions relate to the assessment of whether a fund manager exercises significant influence over a fund. Both tentative agenda decisions on this topic published in September 2014 and November 2016 proposed that the matter be deferred to the Equity Accounting research project. None of the decisions have been finalised.

The Board has also decided to issue an amendment to IAS 28 to clarify that long term interests that form part of the net investment in associate or joint venture are not accounted for using the equity accounting, but instead in accordance with IFRS 9. This amendment included in the 2015-2017 cycle of the Annual Improvements Exposure Draft.

August 2002 – reciprocal interests

The IC considered circumstances in which A owns an interest in B and B holds an interest in A (reciprocal interests or cross holdings) and whether guidance should be included when cross holdings are accounted for using the equity method under IAS 28. The IC decided that IAS 28 requires elimination of reciprocal interests through application of consolidation concepts and decided not to add this issue to its agenda.

July 2009 – potential effect of revised IFRS 3 and IAS 27 on equity method accounting – issue of shares

The IC considered how the investment in an associate should be accounted for when there is an issue of shares in the investee which results in dilution of the existing interest. The IC concluded that IAS 28 provides guidance on accounting for amounts recognised in other comprehensive income when the investor's ownership is reduced but significant influence is retained. Therefore the IC decided not to add the item to its agenda.

Summary of IAS 28 rejections

Topic	*Conclusion*
August 2002 – reciprocal interests.	The IC decided not to develop an interpretation for the accounting of reciprocal interests. The IC determined that IAS 28 already required the elimination of reciprocal interests.
July 2009 – potential effect of revised IFRS 3 and IAS 27 on equity method accounting.	The EITF of the FASB considered whether the acquisition of an associate should be accounted for using a 'cost accumulation' method or an approach similar to IFRS 3 for acquisition of subsidiaries. The IC considered these issues and concluded the standard is clear that the initial cost of an investment in an associate comprises its purchase price and any directly attributable expenditures necessary to obtain it. The IC rejected the issue.
July 2009 – potential effect of revised IFRS 3 and IAS 27 on equity method accounting.	The standard (paragraph 25) applies to all reductions of interests regardless of the form they are effected. Therefore the IC decided not to add the item to its agenda.
May 2013 - Associates and common control	The IC noted that accounting for the acquisition of an interest in an associate or joint venture under common control would be better considered within the context of broader projects on accounting for business combinations under common control and the equity method of accounting. The IC decided not to take this issue onto its agenda.

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IFRS Reporting

IFRS is the common global financial reporting language. Major new standards for financial instruments, revenue recognition and leasing present significant challenges to preparers of financial statements. You'll find the latest practical application guidance from the experts at PwC here.

IFRS insight

PwC's tools, guidance and commentary on IFRS.

Financial instruments Revenue Leases

The IFRS 15 Mole

The IFRS 15 mole is back and has a new case! Katie Woods, PwC revenue specialist, is helping him get to the bottom of accounting for free gifts!

FREE

Suspects

Accounting for free gifts

Incident description

Performance obligations (POs) are promises to a customer that arise every time they enter a contract to supply a good or service. Once the contract has been identified, the next step is to identify the POs. The 'incidents' start when not all of the POs are identified resulting in the incorrect measurement of revenue or recognition in the wrong period.

Not all POs need to be explicitly stated in the contract. Sometimes the buyer has a valid expectation of an 'extra' good or service being provided for example, a customary business practice or stated policy. This is an additional PO and needs to be considered in the application of IFRS 15.

The standard also helps by defining a PO as a good or service that is distinct. If a PO is distinct it is capable of being used on its own or together with resource available to the customer. So what have I found?

Facts

Retailers transfer goods directly to their customers on or close to the date the goods are paid for, so many retailers believe that the implementation of IFRS 15 will be straightforward. This could be true.

Retailers, however, often offer incentives, like free goods, coupons or loyalty points to keep customers returning to their stores. They may need to take a closer look at the standard to consider the accounting consequences.

Many argue that the cost of the free goods is a marketing expenses. However, if a free good is promised to a customer, then it should be treated as a separate PO.

For example, if a customer buys a jumper and receives a voucher for a free scarf if they buy another jumper in the following month, part of the consideration for the initial jumper would need to be allocated to the scarf.

The future offer is referred to as a material right under IFRS 15. How much is allocated to each item (or PO), will depend on how the transaction price is allocated.

Loyalty points are in substance the same as a coupon or free good. Some of the consideration received in exchange for the goods sold at the time when the points are earned should be deferred until the points are exchanged for goods or services in the future.

The loyalty point is providing a right to a good or service to the customer, and therefore is a distinct PO. Again, the amount deferred will be a subject of one of my later investigations.

Recommendations

The new revenue standard has a clear 5 step approach to determine when and how much revenue should be recognised. Management needs to think about all the promises being offered to the customer in step 2, identify POs, including those which are implicit. A promise deemed to be free or a marketing tool is probably a PO.

Further investigations

Further investigation is required to identify all performance obligations in a transaction. A free good can be a performance obligation.

Cannon Street Press

Editor's choice

Post Implementation Review of IFRS 13, Fair Value

The staff summarised their initial outreach and recommended the Board move to the next steps of the process and issue a request for information. The Board tentatively agreed. The Board also tentatively agreed the scope of the PIR including:

- disclosure;
- unit of account (lovingly known as the P*Q debate!);
- highest and best use; and
- applying judgements in the standard – for example what is an active market etc.

The PIR will also explore the need for education on measuring the fair value of biological assets and unquoted equity instruments.

Other Highlights

Standard Setting Projects

Insurance

The Staff updated the Board about the progress on IFRS 17. The Staff have completed the external editorial review process (the fatal flaw review) and there are a number of matters they wanted to confirm with the IASB at the February meeting. However, there were no fundamental questions on the model and the Staff expects to publish IFRS 17 in May 2017. There is support for an IFRS 17 Transition Resource Group ('TRG') and they are considering the objective and composition of this group.

Conceptual Framework

The Board continued to discuss the ongoing conceptual framework. At this meeting they focused on measurement. They covered factors specific to initial measurement and scenarios where there might be more than one measurement basis.

IFRS Maintenance

IFRS 9 - Symmetric Prepayment options

The Board tentatively decided to propose a narrow scope amendment to IFRS 9 as a result of discussions on financial assets with symmetric prepayment options. A symmetric 'make whole' pre-payment option allows the borrower to prepay the instrument at an amount that reflects the instrument's remaining contractual cash flows discounted at a current market interest rate. The amendment proposes that the option would be eligible to be measured at amortised cost or fair value through OCI if certain conditions are met. The Board will consider timing of the ED at their February meeting.

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

The leases lab

IFRS 16 gives rise to many challenges, so Professor Lee Singh starts a new experiment – this time with his assistant Dr Holger Meurer

Hypothesis

A lessee must recognise a right-of-use asset and a lease liability for almost every lease contract under the new standard. Substitution rights may be an obvious way to avoid lease accounting. If there is a substitution right, the leased asset can't be identified and hence there is no lease to recognise!

Testing and analysis

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. There is, however, no identified asset if the supplier has a right to substitute the asset and that right is substantive.

Substitution rights are substantive if the supplier;

- has the practical ability to substitute an alternative asset throughout the period of use; and
- benefits economically from substituting the asset.

The supplier's substitution right is not substantive if the supplier has a right or obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event.

Let's look at some examples:

Example 1

A customer enters into a contract with a supplier for the right to control the use of an asset for six years. The supplier has the right to substitute the underlying asset at three years from the commencement of the contract, that is, only at that particular point in time.

Example 2

A customer enters into a contract with a supplier for the right to control the use of an asset for six years. The supplier has the right to substitute the underlying asset throughout the term of the contract if a particular event occurs.

In both examples, the supplier does not have the right to substitute the asset throughout the entire period of use and therefore the substitution right is not substantive. The lease term in both examples is six years.

Conclusion

Unfortunately, the hypothesis is incorrect.

A substitution right by itself is not sufficient to prevent the contract from being a lease. The substitution right also needs to be substantive and available throughout the period of use.

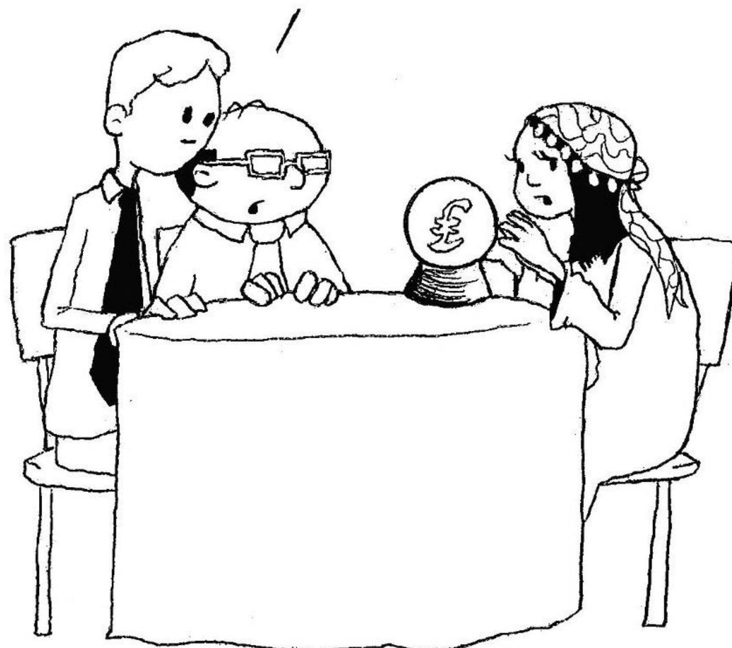
Practical application

The analysis of whether or not a substitution right is substantive is often complex. There is a range of factors that need to be considered such as the benefits and costs of substituting.

Substantive substitution rights might allow customers to avoid lease accounting. However, suppliers should weight this 'desirable outcome' against any practical aspects and inconvenience that allowing such a substantive right might entail.

For more on substitution rights and the assessment of whether or not they are substantive, see our In depth, IFRS 16 – A new era of lease accounting.
Our full range of leases content can be found on PwC Inform, including videos on various aspects of the new standard.

The bit at the back ...



Business combinations and adoption of IFRS

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