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Accounting Standards update for 2015 year ends and future developments

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INTRODUCTION

This bulletin provides an update on financial reporting requirements impacting PNG entities as at 31 December 2015. It highlights the IFRS standards and interpretations issued by the International Accounting Standards Board (IASB) as at 25 January 2016 and other topical accounting issues that PNG entities should consider in their 2015 and subsequent years reporting.

The PNG accounting profession, through the Accounting Standards Board (ASB) and with the support of CPAPNG, has adopted International Financial Reporting Standards (IFRS) as the applicable accounting framework for use by all entities preparing general purpose financial statements in PNG. Although the ASB has not formally met since 2007 to specifically approve all subsequent new and revised IFRS as approved financial reporting standards, all such changes form part of PNG GAAP as having authoritative support within the accounting profession in PNG. Accordingly, general purpose financial statements are required to be prepared in accordance with all applicable and effective IFRS and interpretations as issued by the IASB in order to comply with the PNG Companies Act.

IFRS 16 'LEASES' FINALLY ISSUED

On 13 January 2016, the IASB finished its long-standing project on lease accounting and published IFRS 16, 'Leases', which replaces the current guidance in IAS 17. This will require far-reaching changes in accounting by lessees in particular.

The standard applies to annual periods beginning on or after 1 January 2019, with earlier application permitted if IFRS 15, 'Revenue from Contracts with Customers', is also applied.

Key provisions

Under IAS 17, lessees were required to make a distinction between a finance lease (on balance sheet) and an operating lease (off balance sheet). IFRS 16 now requires lessees to recognise a lease liability reflecting future lease payments and a 'right-of-use asset' for virtually all lease contracts. The IASB has included an optional exemption for certain short-term leases and leases of low-value assets; however, this exemption can only be applied by lessees.

For lessors, the accounting stays almost the same. However, as the IASB has updated the guidance on the definition of a lease (as well as the guidance on the combination and separation of contracts), lessors will also be affected by the new standard. At the very least, the new accounting model for lessees is expected to impact negotiations between lessors and lessees.

Under IFRS 16, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

Impact

IFRS 16 is likely to have a significant impact on the financial statements of a number of lessees.

The new standard will affect both the balance sheet and related ratios, such as debt/equity ratios. Depending on the particular industry and the number of lease contracts previously classified as operating leases under IAS 17, the new approach will result in a significant increase in debt on the balance sheet.

In the income statement, lessees will have to present interest expense on the lease liability and depreciation on the right-of-use asset. In comparison with operating leases under IAS 17, this will change not only the allocation of expenses but also the total amount of expenses recognised for each period of the lease term. The combination of a straight-line depreciation of the right-of-use asset and the effective interest rate method applied to the lease liability will result in a higher total charge to profit or loss in the initial years of the lease, and decreasing expenses during the latter part of the lease term.

The new guidance will also change the cash flow statement, because lease payments that relate to contracts that have previously been classified as operating leases are no longer presented as operating cash flows in full. Only the part of the lease payments that reflects interest on the lease liability can be presented as an operating cash flow (if it is the entity's policy to present interest payments as operating cash flows). Cash payments for the principal portion of the lease liability are classified within financing activities. Payments for short-term leases, for leases of low-value assets and variable lease payments not included in the measurement of the lease liability are presented within operating activities.

Transition

IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted, but only in conjunction with IFRS 15, 'Revenue from Contracts with Customers'. In order to facilitate transition, entities can choose a 'simplified approach' that includes certain reliefs related to the measurement of the right-of-use asset and the lease liability, rather than full retrospective application; furthermore, the 'simplified approach' does not require a restatement of comparatives. In addition, as a practical expedient entities are not required to reassess whether a contract is, or contains, a lease at the date of initial application (i.e. such contracts are "grandfathered").

Start preparing now

Entities should ensure that they have implemented systems and processes to identify all lease contracts, to capture the information needed to determine the measurement of the right-of-use asset and the lease liability, and to prepare the new disclosures.

OTHER TOPICAL ISSUES

This section summarises some accounting hot topics raised by global regulators that may impact your 2015 and subsequent year ends.

Key reminders for impairment reviews under IAS 36

In the current economic environment, impairment is a growing area of concern. Globally, regulators remain focused on this area and continue to push for increased transparency in disclosures and challenge the assumptions used by preparers.

Preparers should consider the interest rate environment, PNG country risk, foreign exchange, commodity prices and property values when performing impairment reviews and identifying triggers.

The key points in impairment testing are:

- Look out for impairment triggers (both internal and external factors). For example, when the market capitalisation of a listed entity is significantly lower than the carrying amount of its net assets. An example of an external trigger is the current decrease in many commodity prices.
- For the value-in-use model, which is a pre-tax model, key assumptions should stand up against external market data. Cash flow growth assumptions should be comparable with up-to-date economic forecasts.
- IAS 36 requires that the value-in-use model uses pre-tax cash flows discounted using a pre-tax discount rate. In practice, pre-tax discount rates are not commonly available, therefore the next step is often to determine fair value less costs of disposal (FVLCD).
- In assessing impairment, the carrying value should be determined on a consistent basis as the recoverable amount.

The required disclosures in IAS 36 are extensive. IAS 36 requires disclosure of the key judgements and assumptions (those that the recoverable amount is most sensitive to) and related sensitivity analysis. Regulators have observed that, whilst the long-term growth rate used to extrapolate cash flow projections (to estimate a terminal value) and the pre-tax discount rate are important, they are not 'key assumptions' on which the cash flow projections for the period covered by the most recent budgets or forecasts are based. Therefore, attention should also be paid to the discrete growth rate assumptions applied to the cash flows projected to occur before the terminal period.

Fair value measurement and related disclosures under IFRS 13

IFRS 13, 'Fair value measurement' has been effective since 2013; however, preparers are still coming to grips with the guidance on fair value measurement techniques and the increased disclosures required.

Some key reminders are:

Measurement

- valuation techniques shall be compliant with the IFRS requirements;
- the use of observable inputs shall be maximised and the use of unobservable inputs (internal company data) minimised;
- issuers should use quoted prices in an active market without any adjustment (i.e. a Level 1 input) where available.

Disclosure

Issuers should provide relevant information to meet the standard's objective, including when the fair value is determined by third parties. Issuers should provide a description of:

- the valuation technique;
- the inputs used (e.g. quantitative info for significant unobservable inputs) - Level 2 and 3;
- any changes in the valuation techniques and reasons;
- levels of FV hierarchy;
- the sensitivity to changes in unobservable inputs;
- whether current use differs from its highest and best use.

IFRS 12, 'Disclosure of interests in other entities', practical application issues

Significant judgements and assumptions

IFRS 12 specifically requires disclosure of significant judgements and assumptions the entity has made (and changes to those judgements and assumptions) in determining that it has control, joint control or significant influence over an investee. Examples include situations when an entity holds more than 50% of the voting rights but concluded that it does not have control, or, in contrast, when an entity has de-facto control.

Disclosure of summarised financial information about material joint ventures and associates

Paragraph 21(b)(ii) of IFRS 12 requires the disclosure of summarised information on an individual basis for each joint venture or associate that is material to the reporting entity. This information should be 100% of the joint venture or associate's results as reported in its IFRS financial statements, not the entity's share of those amounts. The IFRSIC confirmed in January 2015 that there is no provision in IFRS 12 that permits nondisclosure of this information.

Presentation and classification in cash flow statements under IAS 7

IAS 7 "Statement of cash flows" is one of the oldest accounting standards still applicable without significant revision since it was issued in 1994. However, regulators still highlight classification of cash flows in a cash flow statement as an area where they continue to challenge companies and find recurring errors. Often cash flow statements are prepared late in the financial reporting process and therefore do not receive the same level of scrutiny as the other primary statements. The choice of whether an item is an operating, financing or investing activity can, in some cases, be judgemental. However common errors remain an issue.

The classification definitions are:

- Operating activities – "the principal revenue-producing activities of the entity and other activities that are not investing or financing activities".

- Investing activities – "the acquisition and disposal of long-term assets and other investments not included in cash equivalents". "Only expenditures that result in a recognised asset in the balance sheet are eligible for classification as cash flows from investing activities".

- Financing activities – "activities that result in changes in the size and composition of the contributed equity and borrowings of the entity".

Below are some of the common errors encountered:

- Acquisition of assets by way of finance lease should be excluded from investing activities; rather the capital element of finance lease repayments should be presented as an outflow under financing activities. The interest expense element is included under either operating or financing cash flows depending upon the entities policy for presenting interest costs.

- Cash flows from hedging activities must be classified in the same manner as the transaction subject to the hedge.
- Purchases of own shares must be classified as a financing activity and not investing activities.
- Loans to related parties should be classified as an investing activity and not financing activities.
- Transaction costs incurred in a business combination must be classified within operating and not investing activities.
- Payments to non-controlling interests should be classified as a financing activity.
- Material cash flows relating to additional or exceptional activities should be clearly presented in the cash flow statement.
- Other points of focus where errors occur or better disclosure is required are non–cash transactions and where it is appropriate to use netting.

Breaches of banking covenants and presentation of borrowings

The current economic downturn and consequent reduction in profitability and cash flows has put increased focus on compliance with bank covenants.

An entity should classify a borrowing as current under IAS 1 if it does not have an unconditional right at the balance sheet date to defer settlement for at least 12 months after the end of the reporting period. Where an entity is in breach of banking covenants at the period end and the breach causes the entity to lose the unconditional right to avoid settling within 12 months, the whole borrowing is a current liability at the balance sheet date if the breach has not been waived by the lender before the period end. Even where covenant waivers are subsequently received from the lender, and where borrowings have been restructured in the following year, the financial statements should present the borrowings based on their contractual maturity at the period end. A post-period-end waiver is a non-adjusting post balance sheet event under IAS 10.

IFRS CHANGES APPLICABLE FOR DECEMBER 2015 YEAR ENDS

There are only a few minor IFRS changes effective for accounting periods being on or after 1 January 2015:

- Amendment to IAS 19 regarding defined benefit plans (effective 1 July 2014). These narrow scope amendments simplify the accounting for contributions to defined benefit plans that are independent of the number of years of employee service.

- Annual improvements 2012 (effective 1 July 2014) makes minor changes to IFRS 2, IFRS 3, IFRS 8, IFRS 13, IAS 16, IAS 37 and IAS 39.

- Annual improvements 2013 (effective 1 July 2014) makes minor changes to IFRS 1, IFRS 3, IFRS 13 and IAS 40.

IFRS DEVELOPMENTS EFFECTIVE FOR SUBSEQUENT PERIODS

The following is a full list of the new and revised IFRS effective for accounting periods beginning on or after 1 January 2016, although early adoption is permitted:

- Amendment to IFRS 11 “Joint arrangements” on acquisition of an interest in a joint operation (effective 1 January 2016). These amendments provide new guidance on how to account for the acquisition of an interest in a joint operation that constitutes a business.

- Amendment to IAS 16 “Property, plant and equipment” and IAS 41 “Agriculture”, regarding bearer plants (effective 1 January 2016). These amendments require bearer plants to be accounted for in the same way as property, plant and equipment because their operation is similar to that of manufacturing. The produce growing on bearer plants will remain within the scope of IAS 41.

- Amendment to IAS 16 “Property, plant and equipment” and IAS 38 “Intangible assets”, on depreciation and amortisation (effective 1 January 2016). These amendments clarify that the use of revenue-based methods to calculated depreciation and amortisation is not appropriate because revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits embodied in the asset.

- IFRS 14 “Regulatory deferral accounts” (effective 1 January 2016) permits first-time adopters to continue to recognise amounts related to rate regulation in accordance with their previous GAAP requirements when they adopt IFRS.

- Amendments to IAS 27 “Separate financial statements” on the equity method (effective 1 January 2016). These amendments allow entities to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate financial statements.

- Amendments to IFRS 10 "Consolidated financial statements" and IAS 28 "Investments in associates and joint ventures" (original effective date of 1 January 2016 now postponed) in relation to the sale or contribution of assets between an investor and its associate or joint venture. The main consequence of the amendments is that a full gain or loss is recognised when a transaction involves a business (whether it is housed in a subsidiary or not). A partial gain or loss is recognised when a transaction involves assets that do not constitute a business, even if these assets are housed in a subsidiary.

- Annual improvements 2014 (effective 1 January 2016) makes minor changes to IFRS 5, IFRS 7, IAS 19, and IAS 34.

- Amendments to IAS 1 "Presentation of Financial Statements" (effective 1 January 2016) clarify guidance in IAS 1 on materiality and aggregation, the presentation of subtotals, the structure of financial statements and the disclosure of accounting policies.

- Amendment to IFRS 10 and IAS 28 (effective 1 January 2016) on investment entities applying the consolidation exemption. The amendments to IFRS 10 clarify that the exception from preparing consolidated financial statements is available to intermediate parent entities which are subsidiaries of investment entities. The exception is available when the investment entity parent measures its subsidiaries at fair value. The amendments to IAS 28 allow an entity which is not an investment entity, but has an interest in an associate or joint venture which is an investment entity, a policy choice when applying the equity method of accounting.

- IFRS 15 "Revenue from contracts with customers" (effective 1 January 2018) is a converged standard from the IASB and FASB on revenue recognition. The core principle of IFRS 15 is that an entity recognises revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

  An entity recognises revenue in accordance with that core principle by applying the following 5 steps:

  1. Identify the contract(s) with a customer
  2. Identify the performance obligations in the contract
  3. Determine the transaction price
  4. Allocate the transaction price to the performance obligations in the contract, and
  5. Recognise revenue when (or as) the entity satisfies a performance obligation.

  IFRS 15 also includes a cohesive set of disclosure requirements that will result in an entity providing users of financial statements with comprehensive information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity's contracts with customers.

  Almost all entities will be affected to some extent by the significant increase in required disclosures. But the changes extend beyond disclosures, and the effect on entities will vary depending on industry and current accounting practices. Entities will need to consider changes that might be necessary to information technology systems, processes, and internal controls to capture new data and address changes in financial reporting.

- IFRS 9, 'Financial Instruments" (effective 1 January 2018) replaces the guidance in IAS 39 with a standard that is less complex and principles based. The new standard addresses the classification, measurement and derecognition of financial assets and financial liabilities, relaxes the requirements for hedge accounting and introduces an expected credit losses model that replaces the current incurred loss impairment model.

- IFRS 16, "Leases" (effective 1 January 2019) replaces the guidance in IAS 17 and will have a significant impact on accounting by lessees. The previous distinction under IAS 17 between finance leases and operating leases for lessees has been removed and IFRS 16 will require a lessee to recognise a lease liability representing future lease payments and a 'right-of-use asset' for virtually all lease contracts. There is an optional exemption for certain short-term leases and leases of low-value assets.

- Narrow scope amendment to IAS 7 (effective 1 January 2017) 7 require additional disclosures that will enable users of financial statements to evaluate changes in liabilities arising from financing activities. This includes changes arising from cash flows, such as drawdowns and repayments of borrowings, and non-cash changes, such as acquisitions, disposals and unrealised exchange differences.