The financial reporting screws are tightening: IFRS9 & IFRS15

IFRS 9, the standard which applies to periods beginning on or after 1 January 2018, affects not only large financial institutions but non-financial entities too. IFRS 15, which deals with how to report on revenue arising from customer contracts, focuses on timing and how to cope with variables. Nicholas Joel from our Business Services division helps you to navigate the rules.

IFRS 9

Revenue wasn't the only recent shake-up that rocked the accounting world. There is also the implementation of IFRS 9 Financial Instruments to contemplate.

There's a common belief that IFRS 9 is applicable only to large financial institutions. But that's not true. Not only does IFRS 9 also affect non-financial entities, it can have a significant impact on financial reporting.

IFRS 9 replaces IAS 39 Financial Instruments – Recognition and Measurement for periods beginning on or after 1 January 2018. The implementation of the new standard was intended to eradicate the inconsistencies of IAS 39 relating to how entities manage risk and the timing of recognition of the credit losses on receivables.

IFRS 9 addresses accounting for financial instruments and deals with three main elements: classification and measurement of financial instruments; impairment of financial assets; and hedge accounting.

Where an entity holds equity investments or financial assets at amortised cost, there are likely to be consequences from the adoption of IFRS9. These might include:

1. Immediate recognition of credit losses. Entities must recognise a 12-month expected credit loss on acquisition of a financial asset.
2. Movement in fair value of investments. It's no longer possible to carry equity investments at cost. Instead they must be measured at fair value, with any gain or loss recorded in profit or loss as they arise.

What are they key changes?

Overall, the changes with IFRS 9 relate to:

1. Classification and measurement of financial assets and liabilities
To measure a financial asset after initial recognition, IAS 39 classified financial assets under four categories: financial assets at fair value through profit or loss; held-to-maturity investments; loans and receivables; and available-for-sale financial assets.

With IFRS 9, these classifications have gone. After initial recognition, an entity must now measure financial assets at amortised cost, fair value through other comprehensive income (FVTOCI) or fair value through profit or loss (FVTPL).

The classification of financial assets will depend on the entity's business model for managing these, and on the contractual cash flow characteristics of the financial asset.

2. Embedded derivatives
Where a hybrid instrument contains a host contract which is an asset within the scope of IFRS 9, the embedded derivative will not be separated from the host contract. This means the classification rules in IFRS 9 will apply to the hybrid instrument as a whole.

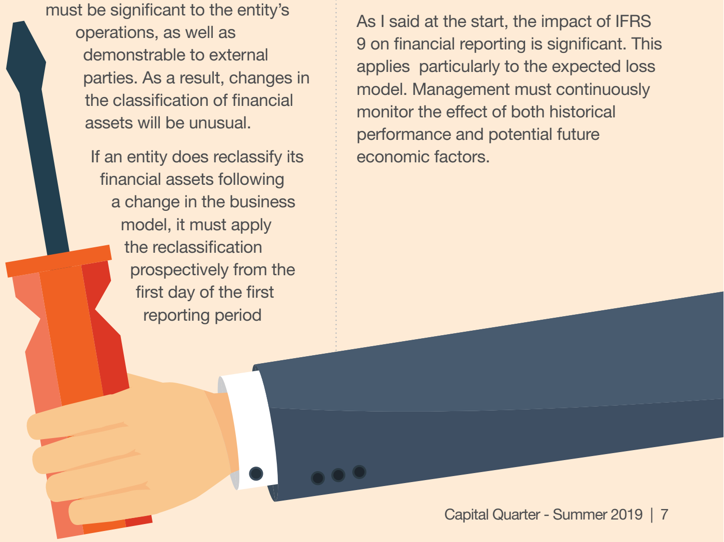
Under IAS 39 the embedded derivative and the host contract were separated if they were not 'closely related'.

The entity also had an option to classify the hybrid instrument at FVTPL in its entirety, subject to certain conditions. This option is still available under IFRS 9, where the host asset is not within the scope of IFRS 9.

3. Reclassification of financial assets and liabilities
IFRS 9 allows an entity to reclassify its financial assets if it changes its business model for managing those assets.

But, for this to apply, these changes must be significant to the entity's operations, as well as demonstrable to external parties. As a result, changes in the classification of financial assets will be unusual.

If an entity does reclassify its financial assets following a change in the business model, it must apply the reclassification prospectively from the first day of the first reporting period following the change. The entity cannot restate any previously recognised gains, losses, or interest.



4. Impairment methodology
IFRS 9 introduces an 'expected loss' approach to account for credit losses. This requires entities to use forward-looking information for earlier recognition of credit losses.

We can blame the financial crisis for this change, as it was thought the IAS 39 impairment approach contributed to the delay in credit losses recognition.

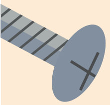
Expected credit losses are recognised in three stages:

1. Performing – a loss allowance equal to 12 months' expected credit losses is recognised with interest income calculated on the gross carrying amount of the asset;
2. Underperforming – a loss allowance equal to the entire expected credit losses, with interest income still calculated on the gross carrying amount;
3. Non-performing - a loss allowance equal to the entire expected credit losses, with interest income calculated on the net carrying amount (i.e. after loss allowance).

Under IAS 39, any loss allowance was recognised at the non-performing stage.

How will the changes affect you?

As I said at the start, the impact of IFRS 9 on financial reporting is significant. This applies particularly to the expected loss model. Management must continuously monitor the effect of both historical performance and potential future economic factors.



IFRS 15

Like IFRS 9, this standard is also effective for reporting periods beginning on or after 1 January 2018. So here are some timely tips on the more confusing elements.

IFRS 15 (Revenue from Contracts with Customers) sets out the principles for reporting the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers and replaces IAS 18 Revenue.

Crucially, the IFRS 15 standard does not change the total amount of revenue an entity must recognise, but just the timing of recognition.

It's true that the new standard has the biggest impact on entities in industries with long-term contracts. But it will also significantly affect those where bundled contracts are common. So it is vital that all entities carefully analyse these changes and make sure they are appropriately reflected in their financial reporting.

Revenue recognition model

IFRS 15 replaced the broad principles of revenue recognition under IAS 18 with a new core principle where an entity must recognise revenue at the time it transfers goods or services to a customer, based on the amount it expects to receive from that customer. The goods or services are deemed to be transferred when the customer has control of them.

The new standard sets out a 'five-step' approach that entities must follow when determining how, and when, to recognise revenue.

Unlike IAS 18, IFRS 15 requires entities to account for two or more contracts entered into at or near the same time with the same customer as a single contract - subject to certain criteria.

IFRS 15 also identifies conditions under which a contract modification must be accounted for as a separate contract. Where these conditions do not apply, the accounting method depends on the nature of the modification.

Other implications

So there may be significant changes to an entity's revenue recognition criteria. But along with financial reporting requirements, entities must also consider wider implications, such as:

- Breaches of loan covenants
- Availability of reserves for dividend distribution
- Changes to key performance indicators.

Variable consideration

One common conundrum is how to recognise revenue when there is a variable consideration element.

For example, revenue contracts in the mining sector can include significant variables that are only finalised several months after shipment to the customer. New specific requirements for such cases mean that amounts are only included in the transaction price if it is 'highly probable' that the amount would not be subject to significant future reversals.

For variable considerations, then, the entity must estimate the sum to which it will be entitled under the contract for the transfer of promised goods or services. IFRS 15 allows one of the following two methods to calculate the estimate:

1. Expected value – the sum of the probability-weighted amounts
2. Most likely amount – the single amount management believe they will receive

Entities should apply the chosen method consistently throughout the life of each contract.

So how could, for example, a mining company deal with the 'high probability of no significant reversals' rule, given commodity price swings? IFRS 15 then requires an estimate of how much of the consideration would likely be immune from such a reversal. This tricky area is seen as a subjective estimate, so involves careful consideration by management.

How we can help

PKF Littlejohn has an experienced team with an in-depth knowledge of IFRS 15 who can offer advice.

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