November 2021

Topical issues to consider when preparing FY21 financial statements

Introduction

In this Insights, we give an overview of the accounting implications of the following topical issues that entities might consider for their coming financial year ends:

1. Impairment reviews of non-financial assets
2. Debt restructurings
3. Configuration and customisation costs in a cloud computing arrangement
4. Supplier financing arrangements
5. Climate change
6. IASB educational guidance on going concern

1. Impairment reviews of non-financial assets

Impairment is an ongoing area of concern for many entities. Entities holding significant amounts of goodwill and intangibles are at greater risk of potential impairment under the current challenging environment. The key points in impairment testing are:

- For the value-in-use ("VIU") model, key assumptions should stand up against external market data. Cash flow growth assumptions should be comparable with up-to-date economic forecasts.

- In times of greater uncertainty, it is likely to be easier to incorporate these uncertainties in impairment testing by using multiple cash-flow scenarios and applying relative probability weightings to derive a weighted average set of cash flows rather than using a single cash flow forecast and attempting to risk adjust the discount rate to reflect the higher degree of uncertainty in the environment.

- With the implementation of MFRS 16 *Leases*, there have been some effects on accounting for impairments of non-financial assets under MFRS 136 *Impairment of Assets*, which includes right of use ("ROU") assets. Entities might not have taken account of these changes if there were previously no impairment indicators in the cash-generating units ("CGUs") to which the ROU assets related. Entities should ensure that they consider the changes to the impairment testing as a result of MFRS 16 if the CGUs include ROU assets.

1. Impairment reviews of non-financial assets (continued)

The key points in impairment testing are (continued):

- MFRS 136 requires that the VIU model uses pre-tax cash flows discounted using a pre-tax discount rate. In practice, post-tax discount rates and cash flows are used which theoretically give the same answer but the need to consider deferred taxes makes this very complicated to achieve. Therefore if a post-tax VIU model results in a 'near miss' the next step should be to determine fair value less costs of disposal ("FVLCD").

- The FVLCD model, which is a post-tax model, must use market participant assumptions, rather than those of management.

- In assessing for impairment, the carrying value should be determined on a consistent basis as the recoverable amount. For example:

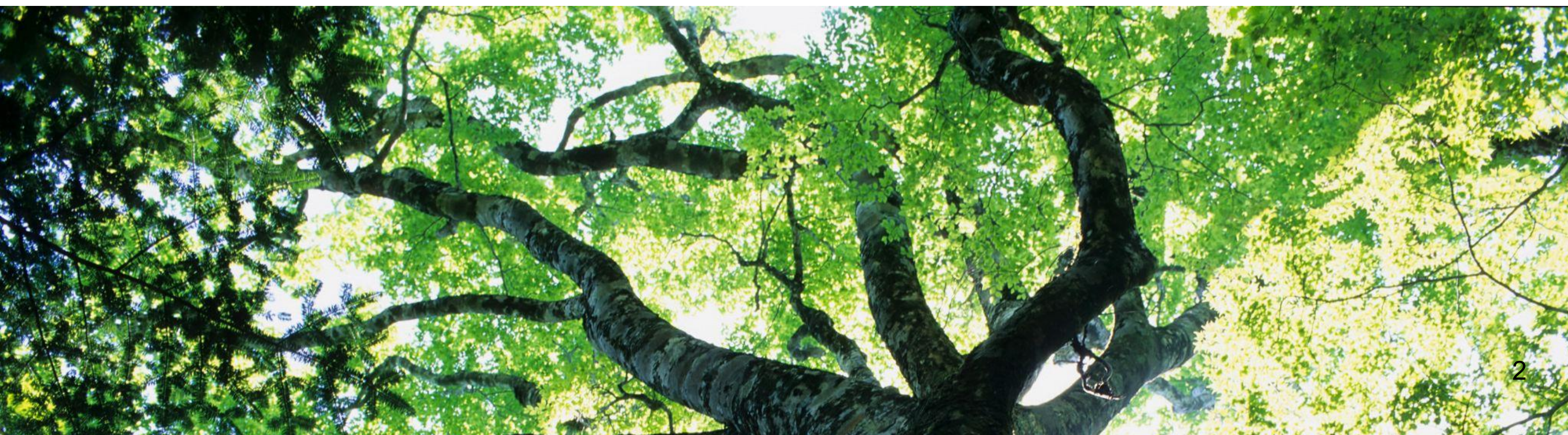
  - Where the recoverable amount is determined using the FVLCD model, the carrying amount tested should include current and deferred tax assets / liabilities (but exclude deferred tax assets for existing tax losses, because these are generally not part of the CGU).

  - Where the VIU model (i.e. pre-tax) is applied, deferred tax assets should not be added to the carrying value and deferred tax liabilities should not be deducted (i.e. are not included in the carrying amount of the CGU). This could result in the carrying value for VIU being higher than the carrying value for FVLCD. However, in situations where there is significant deferred tax upfront, MFRS 136 VIU test may not be the most appropriate method to determine the recoverable amount of a CGU.

- If impairment of goodwill is identified at the group level this will most likely trigger an impairment review of the parent entity's investment in the relevant subsidiaries in the parent's separate financial statements.

  - VIU of an investment in a subsidiary would be determined by the present value ("PV") of expected dividend receipts.

  - The PV of the estimated post tax cash flows from the subsidiary's underlying assets might be used as a proxy for this if the subsidiary has no debt. Otherwise, the PV of expected cash flows should be reduced by the fair value of outstanding debt (both external and inter-company), in order to determine the net amount available for distribution.



1. Impairment reviews of non-financial assets (continued)

Key disclosure requirements

The required disclosures in MFRS 136 are extensive. MFRS 136 requires disclosure of the key assumptions (those that the recoverable amount is most sensitive to) and related sensitivity analysis. Paragraph 25 of MFRS 101 *Presentation of Financial Statements* also requires disclosure of critical accounting judgements and of key sources of estimation uncertainty.

Given the increased uncertainty and volatility in many markets at present, the range of reasonably possible changes has widened which means that more extensive impairment disclosures will typically be required.

Where a reasonable possible change in key assumptions would reduce the headroom (excess of the recoverable amount over the carrying amount) of a CGU to nil, entity is required to disclose this headroom:

- Where the headroom is sensitive to changes in key assumptions, an entity would need to disclose the specific changes in assumptions that would erode headroom to nil (+/– x% in sales growth or discount rates).
- However, in cases where no reasonably possible change would either erode headroom for CGUs when testing goodwill or give rise to a material adjustment to any carrying value in the next year, entities should take care that additional sensitivity disclosures do not give the wrong impression or become confusing to users.

Key assumptions and wider ranging assumptions covering multiple CGUs should be clearly disclosed. Where material, assumptions specific to each CGU should be identified. Changes to assumptions used, such as the discount rate, which has changed significantly from the previous year should be explained.

Furthermore, in an impairment case, the entities would need to clearly disclose what the cause of the impairment was and whether this is based on external data or changes in the entity's own estimates. An entity with a material impairment loss or reversal additionally need to disclose the recoverable amount of the asset(s) or CGU(s) affected [MFRS 136 para 130(e)].

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.

2. Debt restructurings

We continue to see questions on the restructuring of issued debt instruments (e.g. loan facilities or bond financing). This is a complex area of accounting which requires significant judgement. Some of the key accounting considerations are summarised below:

- *Determining whether the new and old debt have substantially different terms* – applying MFRS 9 *FInancial Instruments*, when a financial liability is exchanged or its terms are modified but the liability remains between the same borrower and the same lender, it is necessary to assess if the terms are substantially different. See our *Snapshot* on type of fees to be included in the MFRS 9 ‘10% test’. If the terms are substantially different, the transaction should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

- *Treatment of gain or loss on modification of debt* – when a financial liability measured at amortised cost is modified without this resulting in derecognition, a gain or loss should be recognised immediately in profit or loss. The gain or loss is calculated as the difference between the original contractual cash flows and the modified cash flows discounted at the original effective interest rate.

- *Treatment of fees incurred as part of the renegotiation* – the fees should be recognised immediately or capitalised depending on whether the exchange of debt instruments or modification of terms is accounted for as an extinguishment or not.

3. Configuration and customisation costs in a cloud computing arrangement

The March 2021 IFRS IC update included an agenda decision on Configuration and Customisation ('CC') costs in a Cloud Computing Arrangement which was ratified by the International Accounting Standards Board ("IASB") in April 2021. This will impact entities that incur or have previously incurred CC costs associated with a Software as a Service ("SaaS") cloud arrangement and might result in a change in accounting policy.

This agenda decision might require an entity to re-evaluate the accounting for CC costs incurred in previous reporting periods, in particular if they were capitalised. Agenda decisions often provide explanatory material which can result in voluntary accounting policy changes in accordance with MFRS 108 *Accounting Policies, Changes in Accounting Estimates and Errors* as they arise from 'new information'. Voluntary changes in accounting policies are applied retrospectively unless impracticable. Agenda decisions are effective immediately; an entity would be entitled to sufficient time to assess and implement any change.

The key areas of consideration are as follows:

- *Can the costs be capitalised as an intangible asset?*

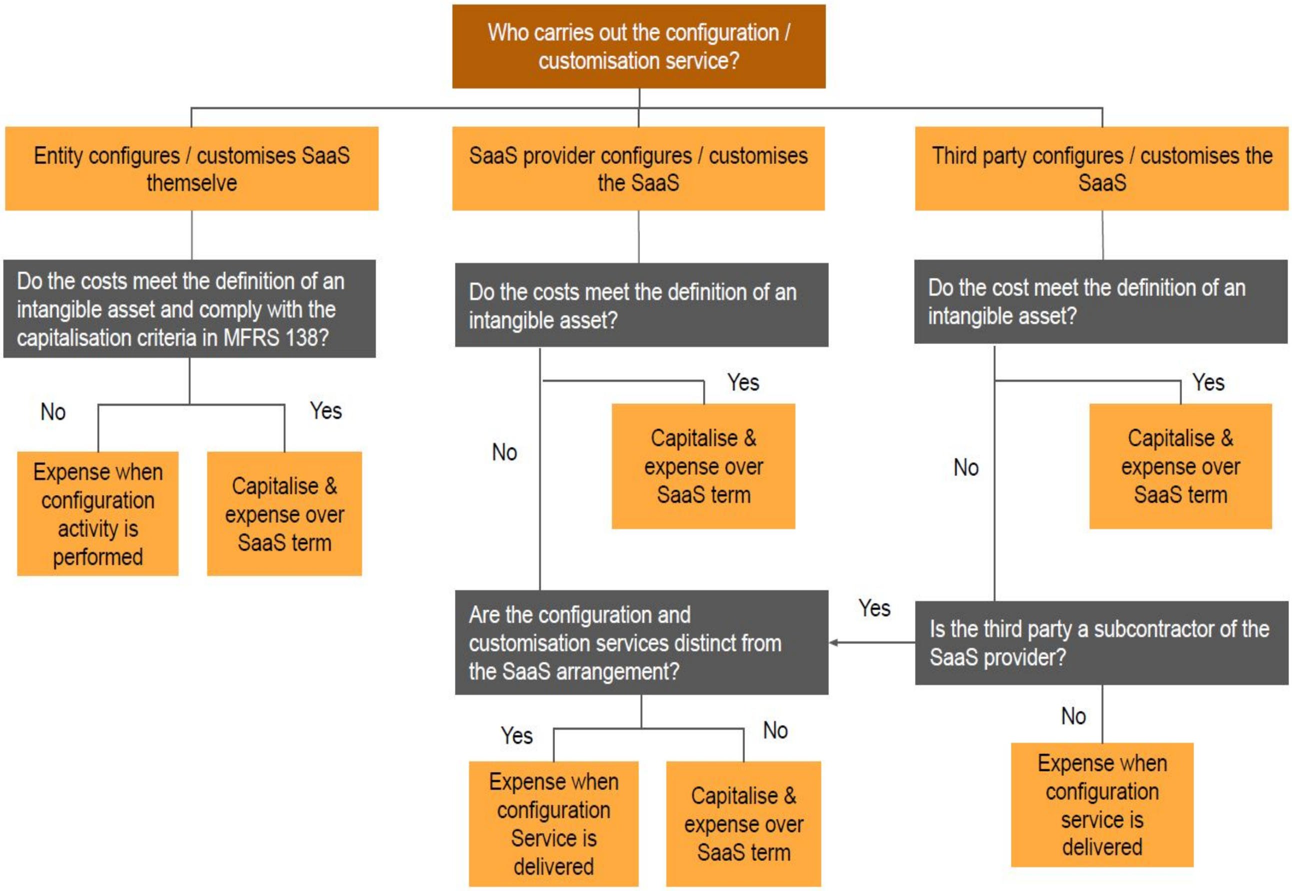
  A customer often would not recognise an intangible asset because it does not control the software being configured or customised and those activities do not create an asset that is separate from the software. In some circumstances however, the additional code is created that might be identifiable and meets the recognition criteria in MFRS 138 *Intangible Assets* in determining whether to recognise additional code as an intangible asset.

- *Can the CC costs be capitalised as a prepayment, or should the costs be expensed when incurred?*

  MFRS 138 requires an entity to expense the cost of a service when it is received. A service is received when it is performed by the supplier in accordance with a contract and not when the entity uses the service. An entity should understand who is performing that service (a third party or the SaaS provider) and whether the service is distinct from the SaaS performance obligation following the criteria in MFRS 15 *Revenue from Contracts with Customers* to conclude when the service is performed. If a third party supplier performs the CC those costs would typically be expensed immediately unless the third party is in substance a subcontractor of the SaaS provider.

3. Configuration and customisation costs in a cloud computing arrangement (continued)

The decision tree below summarises the steps with respect to CC services:



More guidance on how to assess CC costs in a Cloud Computing Arrangement following the March 2021 agenda decision can be found in PwC In depth.

4. Supplier financing arrangements

We continue to see questions around the accounting for supplier financing arrangements. Such arrangements raise the following questions:

- whether an entity has made material use of supplier finance and if such information is transparent from the annual report
- whether the trade payables that are subject to supplier financing are appropriately presented as bank debt or trade creditors
- whether subsequent cash flows are appropriately presented in the statement of cash flows.

In February 2020, the IFRS Interpretations Committee ("IFRIC") was asked to consider both the accounting and disclosure of supply chain finance in corporate entities. In December 2020, the IFRIC concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine the presentation of liabilities that are part of supplier finance arrangements, the presentation of the related cash flows, and the information to disclose in the notes about (e.g. liquidity risks that arise in such arrangements). Consequently, the IFRIC decided not to add a standard-setting project on these matters to the work plan.

In June 2021, the IASB decided to add a narrow-scope standard-setting project to its work plan on supplier finance arrangements. The IASB plans to publish an exposure draft ("ED") in the fourth quarter of 2021. The ED would propose amendments to IAS 7 and IFRS 7 to add disclosure requirements, and 'signposts' within existing disclosure requirements, that would ask entities to provide qualitative and quantitative information about supplier finance arrangements. That information would help investors determine the effects of those arrangements on an entity's liabilities and cash flows.

For further details, refer to our publication *Snapshot: Financial reporting considerations for supplier finance arrangements* and *IFRIC Update December 2020*, *IASB Update July 2021*.

5. Climate change

Climate-related risks are an important topic that might have an impact on an entity's operations and financial performance. MFRS does not explicitly address climate risk, but the principles that underlie various judgements and estimates made in the preparation of the financial statements will often incorporate climate risk factors.

Examples of specific areas entities should consider as climate issues become more significant include "green" loans (i.e. bonds/loans that are issued at an interest rate that is to a certain degree dependent on key performance indicators that are sustainability related) and exchange traded climate credit schemes.

It is also important to note that MFRS 101 has an overarching disclosure requirement; to disclose information if that information is needed to enable investors to understand the effect of particular transactions, other events and conditions on the entity's financial position and financial performance. Therefore, in light of the current focus on, and impact of, climate change, entities should ensure that they have undertaken a rigorous assessment to ensure that all of the material information affecting the financial statements in this respect is provided.

The IASB issued educational material contains a non-exhaustive list of examples regarding how climate risk might affect the measurement and disclosure requirements of various standards and the various paragraphs of those standards that might be referenced in determining how to incorporate such risks. For further information see *PwC In Brief*.

Entities should also ensure that any information on climate related issues is consistent between the financial statements and other public information. For example, if the entity presents a separate sustainability report or management commentary and highlights specific climate related risks, the financial statements' recognition, measurement, presentation and disclosure should be consistent with that information.

6. IASB educational guidance on going concern

On 13 January 2021, the IASB issued this four page *education material* on what needs to be considered when entities provide the going concern disclosure which is required by IAS 1 / MFRS 101. The IASB acknowledges that the stressed economic environment arising from the COVID-19 pandemic has meant entities have seen a significant downturn in revenue, profitability and liquidity, leading to questions over going concern.

The educational material does not provide any new guidance but has been issued to support entities preparing financial statements in this difficult environment. It is a reminder of what IAS 1 / MFRS 101 requires. Read more in our publication *Snapshot: How MFRS 101 disclosures interact with the going concern assessment*.

Do you need further information on this topic?	Contact: Michelle Loh | Assurance Director from PwC Malaysia CMAAS Email: michelle.s.loh@pwc.com | Tel: +60 (3) 2173 0858
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