# Insights

by Capital Markets & Accounting Advisory Services

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# Topical issues to consider when preparing 30 June 2023 MFRS financial statements

## Introduction

In this Insights, we give an overview of the accounting implications of the following topical issues that companies with 30 June 2023 year end might consider when preparing their MFRS financial statements:

1. Impacts of rising inflation and interest rates
2. Impairment reviews of non-financial assets
3. Debt restructurings
4. Lessor forgiveness of lease payments
5. Climate change

There are a number of narrow-scope amendments and annual improvements on MFRS effective 1 January 2022 that are newly applicable for 30 June 2023 year ends as highlighted in Appendix I at the end of this publication.

## 1. Impacts of rising inflation and interest rates

Many companies are experiencing the effect of rising inflation and interest rates which touch all aspects of a company's business including increasing costs such as raw materials and wages, changes in customer behaviour and credit risk, negotiations of contract terms and investment and financing decisions. In turn, the effect on the financial statements is likely to be equally widespread, and companies need to consider the accounting implications for the 30 June 2023 year-end.

Rising inflation and interest rates will affect fair value measurements, expected future cash flows estimates, discount rates used to determine present value of cash flows, impairment indicators and impairment tests. Some of the key MFRS accounting standards companies might consider in this regard include:

- MFRS 9 'Financial Instruments' - the impact on expected credit losses.
- MFRS 13 'Fair value measurement' - the impact on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (e.g. impact on market prices for investment properties).
- MFRS 15 'Revenue from contracts with customers' - the impact on contracts that include a significant financing component at inception.
- MFRS 112 'Income taxes' - the impact on forecasts of future taxable income.
- MFRS 119 'Employee benefits' - in particular the impact on measuring defined benefit pension liabilities.
- MFRS 121 'The effects of changes in foreign exchange rates' - the impact on volatility of exchange rates when assessing whether using an average rate is appropriate.
- MFRS 123 'Borrowing costs' - the potential increase in capitalised borrowing costs.
- MFRS 136 'Impairment of assets' - the impact on impairment indicators as well as cash flows and discount rates (see Section 2 below on impairment reviews of non-financial assets).
- MFRS 137 'Provisions, contingent liabilities and contingent assets' - the impact of discount rates and inflation estimates on provisions including decommissioning obligations, and the recognition and measurement of onerous contracts.

Rising inflation and interest rates may cause significant estimation uncertainty for both short and long duration assets and liabilities. Companies may therefore also need to consider new or expanded disclosures in this area. As a reminder, MFRS 101 'Presentation of financial statements' requires disclosures about sources of significant estimation uncertainty. This includes disclosing information about assumptions that could result in material adjustments to the carrying amount of assets and liabilities within the next financial year, and how sensitive those carrying amounts are to those assumptions. MFRS 101 also requires disclosures about judgements that have a significant effect on the financial statements.

Attention should also be given to all the disclosures for financial instruments in accordance with MFRS 7 'Financial Instruments: Disclosures', in particular those relating to liquidity and sensitivity.

Read further in our publication *Snapshot: Navigating MFRS in periods of rising inflation*.

## 2. Impairment reviews of non-financial assets

Impairment is an ongoing area of concern for many companies in the current economic environment. Companies 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. The fair value less costs of disposal ('FVLCD') model, which is a post-tax model, must use market participant assumptions, rather than those of management.

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.

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 complicated. Therefore if a post-tax VIU model results in a 'near miss' the next step should be to determine FVLCD.

Rising costs are becoming a noticeable issue in many countries that have not suffered significant inflation for many years so it is worth noting that a VIU calculation should incorporate specific price changes as well the effect of general inflation either by:

(a) estimating future cash flows in real terms (i.e. excluding the effect of general inflation but including the effect of specific price changes) and discounting them at a rate that excludes the effect of general inflation or

(b) estimating future cash flows in nominal terms (i.e. including the effect of general inflation) and discounting them at a rate that includes the effects of general inflation.

Where inflation assumptions could have a material impact on the financial statements, additional disclosures may be required to explain how inflation has been incorporated into the VIU.

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).

## 2. Impairment reviews of non-financial assets (continued)

The key points in impairment testing are (continued):

If impairment of goodwill is identified at the group level this will most likely trigger an impairment review of the parent company'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.

With the implementation of MFRS 16, there have been some effects on accounting for impairments of non-financial assets under MFRS 136, which includes right of use ('ROU') assets. Companies 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. Companies should ensure that they consider the changes to the impairment testing as a result of MFRS 16 if the CGUs include ROU assets.

*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 also requires disclosure of critical accounting judgements and of key sources of estimation uncertainty.

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, company is required to disclose this headroom:

- Where the headroom is sensitive to changes in key assumptions, a company 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, companies should take care that additional sensitivity disclosures do not give the wrong impression or become confusing to users.

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.

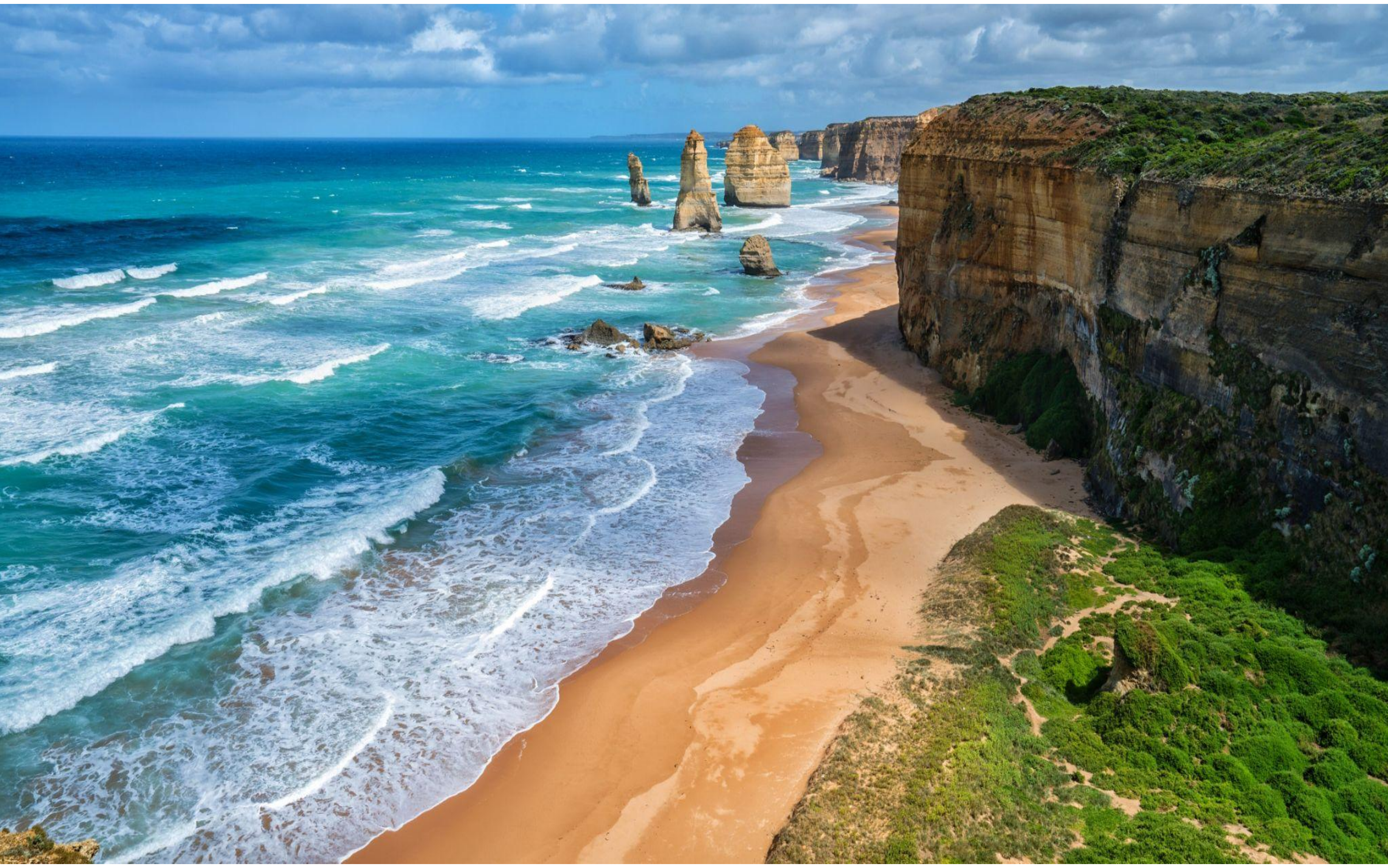
## 2. Impairment reviews of non-financial assets (continued)

*Key disclosure requirements (continued)*

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 companies would need to clearly disclose the cause of the impairment and whether this is based on external data or changes in the company's own estimates. A company 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. Accounting policy disclosures should always be consistent with the basis used in the accounting impairment test.



## 3. 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, 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. Read 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.

## 4. Lessor forgiveness of lease payments

In October 2022, the International Accounting Standards Board (IASB) finalised the agenda decision approved by the IFRS Interpretation Committee on 'Lessor forgiveness of lease payments (IFRS 9 and IFRS 16)'. The agenda decision addresses the accounting from the perspective of the lessor, and in particular:

- How the expected credit loss model in IFRS 9 should be applied to the operating lease receivable when the lessor expects to forgive payments due from the lessee under the lease contract before the rent concession is granted.

- Whether to apply the derecognition requirements in IFRS 9 or the lease modification requirements in IFRS 16 'Leases' when accounting for the rent concession.

Read our *Snapshot* for further details of the agenda decision. As explained in our *Snapshot: The Importance of IFRIC® Agenda Decisions in MFRS Financial Reporting*, in view that MFRS is fully converged with IFRS, Malaysian companies should also consider the IFRIC agenda decision and implement any necessary accounting policy changes on a timely basis when preparing the MFRS financial statements.

## 5. Climate change

Climate-related risks are an important topic that might have an impact on a company'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 companies 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), exchange traded climate credit schemes, estimates used in provisioning and recoverable amount calculations and participation in the voluntary carbon market.

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 company's financial position and financial performance. In many cases, a company's exposure to climate-related risks might not have changed significantly since its last annual reporting period. However, climate-related risks are becoming a more important topic for many users of financial statements.Therefore, in light of the current focus on, and impact of, climate change, companies 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.

Companies should also ensure consistency between financial and non-financial reporting on key climate-related assumptions where such consistency is necessary for compliance with MFRS. For example, if the company presents a separate sustainability report or management commentary and highlights specific climate related risks, the assumptions used in the financial statements' recognition, measurement, presentation and disclosure should be consistent with those disclosed in the sustainability reporting. For further information read *PwC In depth INT2021-11*.

The International Sustainability Standards Board (ISSB) issued its first two sustainability reporting standards on 26 June 2023 as follows:

- IFRS S1 'General Requirements for Disclosure of Sustainability-related Financial Information', the core framework for the disclosure of material information about sustainability-related risks and opportunities across an entity's value chain; and
- IFRS S2 'Climate-related Disclosures', the first thematic standard issued that sets out requirements for entities to disclose information about climate-related risks and opportunities.

For further information read *PwC In brief INT2023-15*.

## Appendix I

The following are amendments to MFRS newly applicable for companies with 30 June 2023 year ends:

**(1) Annual improvements of MFRSs 2018 - 2020**

- ***Amendment to MFRS 1 'First-time adoption of MFRS' - Subsidiary as first-time adopter***

The amendment allows a subsidiary that adopts MFRS later than its parent to elect to measure cumulative translation differences for all its foreign operations based on the carrying amounts that would be included in the parent's consolidated financial statements.

- ***Amendment to Illustrative Example accompanying MFRS 16 - Lease incentives***

The amendment removed the illustration on the reimbursement relating to leasehold improvements by the lessor to avoid potential confusion on whether the reimbursement would meet the definition of a lease incentive in MFRS 16.

- ***Amendment to MFRS 141 'Agriculture' - Taxation in fair value measurement***

The amendment removed the requirement to exclude cash flows for taxation when measuring fair value to align with the requirements in MFRS 13.

- ***Amendment to MFRS 9 - Fees in the 10% test for derecognition of financial liabilities***

This amendment will impact the result of the '10% test' and accordingly affect the amount of the gain or loss recognised in the income statement. All companies, particularly those applying an existing policy of including fees paid to third parties in the '10% test', will be impacted by this amendment. Read our *snapshot* to find out more.

**(2) Amendments to MFRS 116 'Property, plant and equipment' - Proceeds before property, plant and equipment ('PPE') is ready for intended use**

The amendments prohibit a company from deducting from the cost of PPE amounts received from selling items produced while the company is preparing the asset for its intended use. Instead, a company will recognise such sales proceeds and related costs in profit or loss. Read our *Snapshot* to find out more.

## Appendix I (continued)

The following are amendments to MFRS newly applicable for companies with 30 June 2023 year ends (continued):

**(3) Amendments to MFRS 137 ‘Provisions, contingent liabilities and contingent assets’ - Onerous contracts: Cost of fulfilling a contract**

The amendments specify which costs a company includes when assessing whether a contract will be loss-making. Read our *Snapshot* to find out more.

**(4) Amendments to MFRS 3 ‘Business combinations’ - Reference to conceptual framework**

The amendments update a reference in MFRS 3 to the conceptual framework for financial reporting without changing the accounting requirements for business combinations.

**(5) Amendments to MFRS 112 ‘Income Taxes’: International Tax Reform - Pillar Two Model Rules**

The amendments provide a mandatory exception from accounting for deferred taxes arising from the implementation of the Pillar Two model rules released by the Organisation for Economic Co-operation and development. Read our *Snapshot* to find out more.

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