PNG Accounting Technical Update

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Reminders on IFRS 9 and IFRS 15

IFRS 9 and IFRS 15 have become applicable since January 2018 - are you already prepared?

The new IFRS 9 'Financial Instruments' and IFRS 15 'Revenue from contracts with customers' accounting standards became applicable for accounting periods beginning on or after 1 January 2018. Previous technical update bulletins have provided detailed guidance, including specific industry application, on the key changes and considerations for businesses in implementing these new standards. Management and boards should already have considered and addressed the implications on their own businesses, including the impact of any retrospective application to equity as at 31 December 2017.

Therefore, this bulletin is just a high level reminder of some of the main points you should already have considered and you should refer to previous guidance, or to your PwC contact, for more specific advice. You should also consider attending, and send your finance team, to one of the joint **PwC/CPAPNG IFRS Update** training sessions being held in Port Moresby on 12 October 2018 and in Lae on 26 October 2018 respectively.

IFRS 9 Financial Instruments

IFRS 9 simplifies the model for classifying and recognising financial instruments, aligns hedge accounting more closely with common risk management practices, and changes the impairment loss model to an "expected loss" approach which is likely to result in increased doubtful debt provisions.

The main changes are summarised below:

- All equity investments are required to be measured at fair value. Changes in fair value on equity investments held for trading must be taken to the income statement. For other equity investments, entities can make an irrevocable election on initial recognition to record fair value changes in other comprehensive income and not subsequently recycle to the income statement when realised. Dividends from these investments, however, are recognised in the income statement.

- For financial assets that are debt instruments the measurement model is driven by an entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets.

  A debt instrument is measured at amortised cost if: a) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows, and b) the contractual cash flows under the instrument represent solely payments of principal and interest.

  A 'fair value through other comprehensive income' category has been introduced for financial assets that are debt instruments held in a business model whose objective is to both hold and occasionally sell to realise gains.

  An entity must recognise all other financial assets that are debt instruments at fair value through profit or loss.

- Impairment losses will be recognised using the expected credit loss (ECL) model rather than the old incurred loss model. For banks and financial institutions there is a detailed three-stage approach whereby financial assets move through the three stages as their credit quality changes.

For most corporates which only have trade receivables, there is a simplified approach which enables entities to just consider the expected lifetime ECL.

In practice, the new rules mean that most corporate entities will have to record a day 1 loss on their trade and other receivables equal to the lifetime ECL on initial recognition of financial assets that are not credit impaired.

The key difference between the incurred and expected model, is the requirement to consider forward looking scenarios. This purpose is that impairment will be captured earlier and impairment provisions are likely to increase.

We would expect most corporates to develop a provisions matrix to apply to their aged receivables balance to determine their expected credit loss on trade receivables under the new impairment model. The previous methodology of only specifically providing against those debtors for which a loss has been incurred is no longer acceptable, although specific provisioning can still be used for accounts receivable where there is objective evidence of impairment at the reporting date.

A provisioning matrix model should be developed based on past history of bad debt write offs and then appropriately adjusted for consideration of any likely future changes. We recommend that this model is developed and agreed with your auditors well in advance of year end.

- Under the new hedging requirements, an entity will be able to align its hedge accounting more closely with its risk management practices. As a general rule, it will be easier to apply hedge accounting as the bright line 80-125% retrospective hedge effectiveness test has been replaced with an economic relationship effectiveness test.

Although the main impact of IFRS 9 will be on banks and other financial institutions, all corporates will be impacted by the changes to impairment loss provisioning, so management and boards should be ensuring their finance teams are prepared.

IFRS 15 Revenue from contracts with customers

This standard has wide ranging application, since all companies derive some form of revenue.

Whilst for many companies with straightforward revenue streams and contracts the impact of IFRS 15 may not be significant, there are likely to be many entities with more complex revenue contracts that will see a significant impact on their current revenue recognition and measurement practices. For example, contracts with multiple elements, licensing arrangements, outsourcing contracts and contracts with milestone payments can be challenging to understand. It may be difficult to determine what the entity has committed to deliver, how much and when revenue should be recognised.

All companies should analyse their revenue streams to identify the areas that are impacted, and make the necessary changes to their accounting policies and systems to ensure revenue is correctly reported. This is particularly relevant to ensure revenue is appropriately recognised and measured for the cut-off periods at 31 December 2017 and 31 December 2018.

Overview of the main requirements

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. The new standard is based on the principle that revenue is recognised when control of a good or service transfers to a customer – so the notion of control replaces the existing notion of risks and rewards.

An entity recognises revenue in accordance with that core principle by applying the following five 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.

A contract contains a promise (or promises) to transfer goods or services to a customer. Where a contract contains more than one performance obligation, and that performance obligation is distinct in the context of the contract from the other performance obligations, then they should be separated and dealt with separately.

Identifying performance obligations can be straightforward, such as an electronics store's promise to provide a television. But it can also be more complex, such as a contract to provide a new computer system with installation, set-up and training, a three-year software licence, a right to upgrades and ongoing technical support. Entities must determine whether to account for performance obligations separately, or as a group.

The transaction price is the amount of consideration an entity expects to be entitled to from a customer in exchange for providing the goods or services. A number of factors should be considered to determine the transaction price, including whether there is variable consideration, such as rebates, discounts, performance penalties or bonuses, a significant financing component, noncash consideration, or amounts payable to the customer. Variable consideration is included in the transaction price to the extent that it is highly probable that a change in the estimate of the variable consideration would not result in a significant reversal of the cumulative revenue recognised.

The transaction price is allocated to the separate performance obligations in the contract based on the relative standalone selling prices. Where the relative standalone price is not directly observable, IFRS 15 sets how it can be estimated.

Revenue is recognised when (or as) the performance obligations are satisfied. The revenue standard provides guidance to help determine if a performance obligation is satisfied at a point in time or over time. Where a performance obligation is satisfied over time, the related revenue is also recognised over time.

IFRS 15 also provides guidance on accounting for licences of intellectual property, the principal versus agent assessment (gross versus net revenue presentation) and the accounting for contract costs.

The new standard also contains additional 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.

Some key considerations and questions

- Are there multiple parties involved in the transaction? If so, is the entity acting as an agent or principal?
- If there are contract modifications that creates new or changes existing enforceable rights and obligations, should these be accounted for as a separate contract or as an adjustment to the original contract?
- Are there multiple promises in a contract and to what extent do these represent distinct performance obligations?
- Is there any element of variable consideration?
- Is there a significant financing component (> 12 months between transfer of goods and services and time of payment)?
- Is there any consideration payable to the customer?
- When is control over the goods or service transferred to the customer? The timing of revenue recognition could change for some transactions compared to previous guidance, which was more focused on transfer of risks and rewards. IFRS 15 requires judgment in assessing a number of factors to determine at what point in time control has passed.
- Where goods are being transported or shipped, what is the impact of contact, shipping and insurance terms on the point of sale and whether shipment represents a separate performance obligation?

Management and boards should be challenging their finance teams to respond to these questions and provide them comfort that the entity is ready to comply with the new requirements.

Transition adjustments on initial implementation

For both IFRS 9 and IFRS 15, we expect most entities to adopt the modified retrospective application upon implementation. This allows the cumulative effect at the date of application (i.e. in most cases as at 1 January 2018) to be recognised as an opening balance sheet adjustment in equity, with no restatement of comparatives.

For further help on IFRS 9 and IFRS 15 implementation, other IFRS technical issues, accounting advice or training needs please contact our Accounting Technical Support Team or your Assurance Partner:

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