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IFRS Center of Excellence (CoE) Newsletter

Dear all,

Welcome to this edition of the IFRS Newsletter prepared by the Deloitte Luxembourg IFRS Centre of Excellence. We are happy to update you on IFRS matters we found relevant.

Under its publication around enforcement priorities for 2016 financial statements, the European Securities and Markets Authority (ESMA) emphasizes that the areas of focus will constitute:

- Presentation of financial performance
- Financial instruments: distinction between equity instruments and financial liabilities
- Disclosures of the impact of the new standards on IFRS financial statements

These matters are described in detail under European common enforcement priorities for 2016 financial statements.

ESMA has also issued extracts from its enforcement database. We found that certain of these case studies would make an interesting read for IFRS users and have therefore summarized them below under Extract from the EECS's Database of Enforcement.

We share with you an attention item over an IFRS 13 (Fair value measurement) topic: highest and best use.

We will then close with a short report over IFRIC proposed changes relating to the taxation: Uncertainty over Income Tax Treatments and a summary of the projects of the IASB.

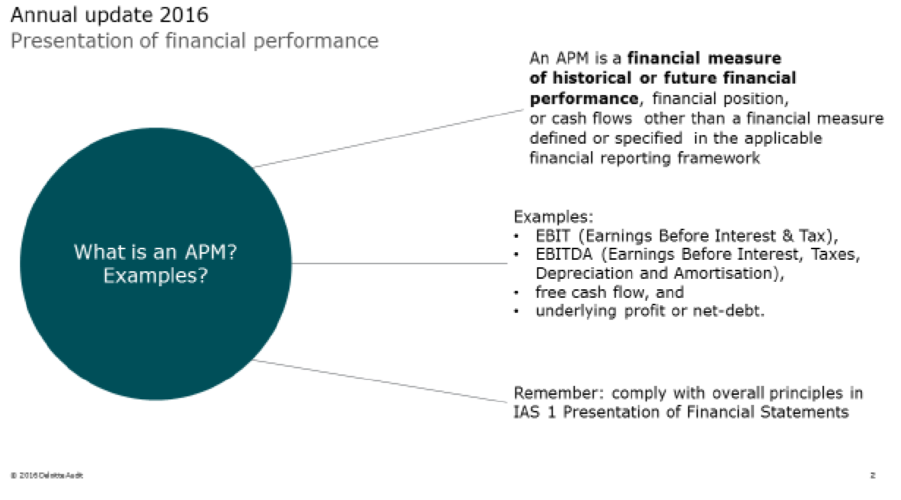
European common enforcement priorities for 2016 financial statements

Presentation of financial performance

In December the IFRS CoE has presented topics relevant for year-end closing. One of these topics has shifted more and more into the attention of regulators – the APM's (Alternative Performance Measures). An APM is a non-GAAP financial measure.

The CSSF have published a press release summarizing guidelines on APM's. Following their review of the 2016 half year financials, the CSSF noted misstatements and omissions related to definitions, reconciliations and explanations of the use of APM's. The CSSF reminds issuers that they need to comply with all requirements for each APM included in the issuers' financial statements.

The disclosure requirements around APM's are mandatory for PIE's and to be considered as best practice for other issuers.



APMs should be meaningfully labelled and defined. There is a particular emphasis on reliability and comparability and a desire to reduce the potential for misleading disclosures.

Further information on this topic:

- CSSF Press Release 16 46
- Questions and answers on APM's
- ESMA Guidelines on APM 05/10/2015
- Statement on Non-GAAP Financial Matters Final Report
- Deloitte APM IFRS in Focus- A practical guide July 2016

Financial instruments: distinction between equity instruments and financial liabilities

ESMA reminds us about the general principle for distinguishing liabilities from equity issued by an entity. We must ask ourselves “does the entity have an unconditional right to avoid delivering cash or another financial asset to settle the contractual obligation?” If not then the contract qualifies as either partly or wholly liability.

Further information on this topic:

- ESMA Public Statement 28 October 2016

Disclosures of the impact of the new standards on IFRS financial statements

Three new standards will be applicable for future financial statements: IFRS 9 & IFRS 15 (1 Jan 2018) and IFRS 16 (1 Jan 2019, after endorsement by the EU). These standards may affect the recognition, measurement and presentation of assets, liabilities, income, expenses and cash flows.

Issuers are encouraged to work as soon as possible to implement these new standards ensuring they are ready when the standards become mandatory. We should all encourage companies to include an assessment of the impact of these standards in the financial statements for the year ended 31 December 2016.

Some guidelines are available regarding the areas where the new standards could have significant changes compared to the current standards, depending on the industry or activity of the company.

For instance, IFRS 15 could have a material and significant impact on the financial statements, if revenue arises from long-term contracts and/or from contracts with multiple-element arrangements (e.g. telecommunication, construction of real estate, aerospace and defense sectors or software companies, etc.). The issuers in the above-mentioned industries need to assess the quantitative impact of the new standards implementation. The standard requires issuers to allocate the transaction price to all the identified performance obligations included in a contract.

In terms of IFRS 9, it is expected that the new standard will have significant impact on the financial institutions (especially on the credit institutions) due to the new classification model for financial assets as well as the implementation of the new impairment model based on expected credit losses. However, ESMA highlights that non-financial entities can also benefit from the changes made to the hedge accounting requirements. The implementation could have also impact on the IT systems and risk management systems, so the financial statements issuers are encouraged to proceed with the implementation as early as possible.

Taking into account the complexity and the significant judgement required under the impairment model, users of financial statements expect that relevant disclosures on management judgements, estimates and assumptions should be provided in order to enable users to evaluate the credit risks to which an issuer is exposed.

ESMA will be issuing later a separate statement on the implementation of IFRS 16 for considering the impact of the new standard on the Financial Statement has exposure to leasing.

As a reminder IAS 8.30 requires that if an entity has not applied a new standard or interpretation that has been issued, but is not yet effective, the entity **must** disclose that fact and any and known or **reasonably estimable information** relevant to assessing the **possible impact** that the new pronouncement will have in the year it is applied.

Further information in this topic:

- ESMA Public Statement 28 October 2016

Extract from the EECS's Database of Enforcement

Below we summarized certain the topics we found interesting for IFRS users throughout the practice:

- Disclosure of amounts of significant categories of revenue
- Identification of unobservable inputs
- IFRS 10 Consolidated Financial Statements – determining whether an entity is an investment entity

Disclosure of amounts of significant categories of revenue

A company which supplies products for 3D printing provided information on various components of revenue (for example sale of machinery and spare parts) in their management report. However in the notes to the financial statements it only outlined two components, being revenue and freight (latter being insignificant).

The enforcer required more granular information regarding revenue. By describing the various accounting policies by category of revenue in the management report, the issuer showed that more significant revenue components than disclosed in the financial statements exist.

Identification of unobservable inputs

A real estate trust fund owns many rental apartment properties. In its annual statements the issuer disclosed that the "capitalization rate," and "stabilized net income," were the key unobservable inputs. The company complied with IFRS 13 paragraph 93 in its treatment of the capitalization rate. However it argued that:

- stabilized net income was built up unit by unit and that

- a variation in the net rental income for an individual unit would not have a significant impact on the fair value measurement of the property portfolio.

Therefore stabilized net income was not a single significant unobservable input.

The enforcer did not agree with the issuers assertions. It noted that the issuer calculated stabilized net rental income based on the rental income from properties on an aggregate basis rather than at an individual until level. Therefore if significant variations did exist in the stabilized net income this could have had an impact on the fair value measurement of the issuer's property portfolio.

IFRS 10 Consolidated Financial Statements – determining whether an entity is an investment entity

IFRS 10 (paragraph 27) determines all relevant application guidance whether an entity is an investment entity. One of these criteria is an investment entity is an entity that measures and evaluates the performance of substantially all its investments on a fair value basis. This would be demonstrated if an entity provides investors with fair value information and measures substantially all of its investments at fair value in its financial statements.

An investment entity would report fair value information internally to the entity's key management personnel, who would use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments as well as to make investment decisions.

In practice, if an entity only shares its periodical estimates of the portfolio's fair value with its board of directors (managers) and not with its shareholders/ investors than the entity does not fulfil the definition of an investment entity. In this case the shareholder should account for its stake in the entity applying the equity method without adjusting its share in the associate's profit or loss to account for changes in the fair value of the investee's investments.

IFRS 13- Fair value measurement: highest and best use

IFRS 13 determines the highest and best use which concept is applicable to fair value measurements of nonfinancial assets. It takes into account a market participant's ability to generate economic benefits by using an asset in a way that is physically possible, legally permissible, and financially feasible.

What does "Highest and best use" mean?
The highest and best use of a non-financial asset or group of nonfinancial assets and nonfinancial liabilities is the use by market participants that maximizes the value of the non-financial asset(s). Important to highlight that the highest and best use is determined from a market participant`s perspective: how the market participants would use a non-financial asset to maximize its benefit or value.

Determining the highest and best use it takes into account a market participant`s ability to generate economic benefit by using the asset in a way that:

- Financially feasible,
- Justifiable and
- Reasonably possible.

As mentioned above, the highest and best use should be determined from the market participants' perspective and if an entity uses an asset under circumstances that are not the highest and best use form that asset, it must disclose that fact.

When should you challenge "highest and best use"?
Typically we would challenge the client's assessment:

- upon changes in use
- when the use of the client is clearly not the highest and best use

Representative examples:
1) A reporting entity may intend to operate a property as a bowling alley, while market participants would pay a higher price to use the asset as a parking lot and zoning requirements allow for this change in use.

In this case, the fair value of the property should be based on its highest and best use (in the principal or most advantageous market) as a parking lot.

2) An entity owns an investment property, which comprises land with an old warehouse on it. It has been determined that the land could be redeveloped into a leisure park. The land's market value would be higher if redeveloped than the market value under its current use so the property's fair value should be based on the land's market value for its potential use.

The highest and best use valuation assumes the site's redevelopment. The market value of the current building is based on the property's highest and best use (as a leisure park). The cost to demolish the warehouse and redevelop the land should be included in determining the fair value of the land. The building's current carrying amount should be written down to zero.

3) Company A has acquired an office in 2015 for EUR 300m. The Board of Directors of Company A has taken the decision to convert the office into a hotel. Company A has applied for the permission to convert it into a hotel, which was obtained already. In addition, Company A has spent additional EUR 30m for obtaining the building permit, on architectural design and additional consultancy fee in the current year (2016). Company A is applying the fair value option to this investment property under IAS 40 and applies IFRS 13 in establishing fair value.
If Company A is only using the building as a hotel the value of the investment property is only resulting in EUR 150m. However, the independent valuer prepared a valuation report and stated that the best alternative for the use of the building would be its development as a mix between 60% residential and 40% hotel. This option would result in a value of EUR 250m. The second option (60% residential and 40% hotel) has not currently been considered by management for the valuation as it has already taken the decision in September of the current year to build a hotel.

Following IFRS 13.27, a fair value measurement of a non-financial asset needs to take into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use. IFRS 13.29 states that entity's intention is not considered if it is different from a typical market participant's behaviour.

The current use of the building is an office. The valuation of the property as an office would presume the highest and best use based on its current use in accordance with IFRS 13.29. However, the independent valuer has stated that the highest and the best use would be the option to develop the office as a mix of residential and hotel. In this case, that option which results in a property value of EUR 250m is to be included in the financial statements as the value of the investment property.

Since the company intends to use the building for different purpose then its highest and best use this is a requirement to disclose this into the Financial Statement (refer to IFRS 13 para 93 (i): for recurring and non-recurring fair value measurements, if the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use.)

Projects of the IASB

The following projects are already accepted by IASB and in drafting phase:

Financial instruments with characteristics of equity – Exposure Draft issued
The project objective is to discuss claims with alternative liability or equity settlement outcomes that are:

- Conditional on rights within the control of the entity; or
- Contingent on the occurrence or non-occurrence of uncertain future events beyond the control of both the entity and holder of the claim.

These headings present challenges, many of which focus on establishing whether the entity has the right to avoid a liability settlement outcome. The scope of the paper is limited to non-derivatives.

Discount rates – Publish Research Summary within 6 months
The objective of the research project is to examine discount rate requirements in IFRS Standards and assess whether there are any inconsistencies the Board should address. One question was raised on when present value measurement should be used and what to disclose regarding discount rates and present value measurement.

Share-based Payment- Exposure Draft issued

This projected seeks to determine the most common areas and main causes of complexity. The initial output of this project was presented to the IASB in November 2015. The IASB decided further research was not required. The main findings from this research project were as follows:

- It is not possible to reduce significantly the complexity that arises in applying IFRS 2 without reconsidering the grant date fair value measurement.
- There may be a need to accurately assess the root-causes of issues that arise in practice before making amendments to standards.

Conceptual framework – revision expected early 2017
The objective of the Conceptual Framework project is to improve financial reporting by providing a more complete, clear and updated set of concepts. These changes may directly affect some entities if they use the Conceptual Framework to develop/ select accounting policies when no IFRS standard specifically applies. However, it is important to note that the Conceptual framework is not a standard and will not have an immediate effect on the financial statements of most reporting entities.

Disclosure Initiative – Materiality Practice Statement – under finalization and Definition of materiality

The objective of this project is to help preparers, auditors & regulators to use judgement when applying the concept of materiality. In essence, it seeks to avoid the disclosure of too much irrelevant (immaterial) information and at the same time that not enough relevant (material) information is presented.

The aim of this project of Definition of materiality is to refine the definition of materiality and clarify its characteristics. In December 2016, the Board decided to accelerate its proposed clarifications and an exposure draft is expected to be published in the first half of 2017. The Expected date the Exposure Draft will be published is June 2017.

Insurance Contracts

This project's objective is to achieve a single principle-based standard to account for all types of insurance contracts. The aim is to enhance the comparability of financial reporting among entities, jurisdictions and capital markets. Phase I of this project resulted in IFRS 4 insurance contracts being issued earlier. However, this standard only resulted in limited improvements. In phase II of this project a new standard will be produced to replace the current IFRS 4. This new standard will achieve the project objective, thus eliminating inconsistencies and weaknesses in existing practices. The final standard is expected to be issued in May 2017.

The following projects are in the pipeline also:

Primary financial statements – Exposure Draft expected in the second half of 2017

An early stage research project, which is examining possible changes to the structure and content of the primary financial statements of financial performance and the statement of cash flows. Early research has focused on:

- Structure and content of the statements of financial performance.
- The potential demand for changes to statement of cash flow and statement of financial position.
- The implications of digital reporting for the structure and content of primary financial statements.

Business Combinations under Common Control (BCUCC)- Discussion Paper expected in the second half of 2017

A BCUCC often concerns group restructurings and reorganisations. Including those related to the preparations for initial public offerings, BCUCC's are excluded from the scope of IFRS 3 Business Combinations, due to the combining entities being controlled by the same party. The aim of this project is to identify if and when an entity should use the previous carrying amounts of a transferred business (carry-over accounting) and to identify if and when it should apply business combination accounting. These accounting procedures will also be assessed to determine if any modifications are required. Priority will be placed on the activity of a parent entity transferring businesses into a newly formed entity as part of a sale, by way of a public offering.

Dynamic risk Management- Discussion Paper expected in the second half of 2017

The goal of this project is to develop an approach which better reflects entities' dynamic risk management activities in their financial statements and to improve the usefulness of the financial information so users can better understand these activities. In essence the IASB wish to align accounting with an entity's dynamic risk management activities. Work to date has focused on the dynamic risk management activities commonly undertaken by banks when they are dynamically managing interest rate arising from open portfolios. A possible approach has been produced. This is called the portfolio revaluation approach (PRA). In this approach, exposures managed in open portfolios would be identified and revalued for changes in the managed risk with any gains/losses measured at fair value through profit or loss.

Goodwill & Impairment – Project has not yet reached decision making stage

Both the IASB & the FASB have active projects covering three topics related to goodwill and impairment:

- Identification of intangible assets acquired in a business combination – Objective: Consider cost benefit reasons to subsume within goodwill any identifiable intangible assets acquired in a business confirmation.
- Subsequent accounting for goodwill - Objective: Consider how costs of current accounting can be reduced without a reduction in quality of information for investors.
- Improving the impairment requirements - Objectives:
    - Consider if impairment test can be simplified & application improved without loss of information.
    - Consider if information can be improved for investors without increasing costs that outweigh the benefit.

Disclosure Initiative: Principles of Disclosures- Exposure Draft expected the second quarter of 2017

Standards-level review of disclosures

The research project is in response to concerns that the way in which disclosure requirements in standards are written contributes to the "disclosure problem." The board plans to develop a set of principles in the form of a new drafting guide for its internal use when developing disclosure requirements in new or amended standards.

Accounting policies & Accounting Estimates (Proposed Amendments to IAS 8)

The amendment objective is to clarify the existing distinction between accounting policies and accounting estimates. In April 2016 the board decided to amend the definitions of accounting policies and changes in accounting estimates in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

For questions related to this and other IFRS topics, please contact the **IFRS Center of Excellence**.

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Leader IFRS CoE