IFRS/HKFRS news

In this IFRS/HKFRS news, we update you common pitfalls of the impairment VIU model. We share with you update from Cannon Street on amendment to IAS 40 and annual improvements to IFRS Standards 2014 – 2016 cycle. Demystifying IFRS 9 series article explains significant increase in credit risk.

In this issue:

Beware of Value in Use

This article talks through the common pitfalls of using value in use (VIU) in an impairment review.

Impairment of non-financial assets under IAS 36 remains a hot topic with regulators and users. Six years past the start of the financial crisis, slow or no growth and low commodity prices continue to challenge companies. These issues and new 'unknowns' such as Brexit are working their way through into impairment testing.

Regulators in the major capital markets that use IFRS now have a fair amount of enforcement experience. There have been a number of recent enforcement actions from regulators focusing on impairment under IAS 36 and VIU has emerged as a theme.

Recoverable amounts under IAS 36, both fair value and VIU can be calculated using a cash flow model. There is a perception that VIU is 'user friendly'. Our recent experience with regulators does not support this view. VIU is a cash flow model that exists only in IAS 36 and has a number of prescriptive rules.

Regulators are increasing their scrutiny of companies that assert application of VIU. Why? Because a regulator may be able to deduce from disclosures, or establish with a few carefully chosen questions, that the company is not following all of the VIU 'guidance'. An approximation of VIU was less worrying during times of strong economic growth, however, regulators are clearly more concerned in the current environment. You need to ensure that if you assert compliance with VIU you are prepared to explain how you have complied with the detailed guidance.

An aspect of VIU that has received increasing attention is the requirement to model 'probable' cash flows. An asset in development, such as an oilfield in development or an acquired IPRD asset may not have 'probable' revenues in the five-year forecast window.

Some question if it is possible to use VIU to test these types of assets. Some regulators have asserted 'no probable cash flows, no VIU'. A company that wants to use VIU will need to do significantly more complex modelling to overcome the absence of probable future cash flows. The cash flow model will need multiple scenarios, each probability-weighted. Risk needs to be included in both cash flows and discount rates so be prepared to use a substantially higher discount rate.

Pre-tax rates and pre-tax cash flows are an obvious and understandable area where it is difficult to comply with IAS 36. There are no observable pre-tax rates available. Modelling out the cash tax flows is very challenging; both parts of that equation are so difficult that it is rarely seen in practice.

VIU doesn't just say 'pre-tax' and 'probable'. The VIU section of the standard has guidance on determining the cash flows to model. Regulators are reading this guidance and challenging the assumptions underpinning VIU cash flows.

We have 'translated' quotes from IAS 36 as follows:

Quote	Translation into plain English
33 (a) base cash flow projections on **reasonable and supportable assumptions** that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. **Greater weight shall be given to external evidence.**	Make good faith estimates. Do not ignore market data.
33 (b) base cash flow projections on the **most recent financial budgets/forecasts approved by management,** but shall **exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance.** Projections based on these budgets/forecasts shall cover **a maximum period of five years,** unless a longer period can be justified.	Do not create a special forecast for your impairment testing. Test the asset or business you own, not the business or asset you hope to make it into. Be prepared to defend your terminal value or specific forecasts beyond the five year period (more below on this).
33 (c) estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or **declining growth rate for subsequent years,** unless an increasing rate can be justified. This growth rate **shall not exceed the long-term average growth rate** for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified	Avoid the classic errors that create the valuation hockey stick in cash flow models: • Model incorporates growth that implies a level of consumption beyond the population of the planet • Growth is greater than that of the competition which is not sustainable over more than the short term. Higher growth or premium cash flows attract more competition.

VIU may be a 'false friend'; difficult to comply with, voluminous disclosures mandated by the standard and easily challenged by regulators.

If a company is using VIU, they should ensure that all of the VIU rules are followed and all VIU disclosures are made.

Amendment to IAS 40

The IASB has issued an amendment to IAS 40, *Investment Property*, clarifying when assets are transferred to, or from, investment properties.

The amendment clarified that to transfer to, or from, investment properties there must be a change in use. To conclude if a property has changed use there should be an assessment of whether the property meets or no longer meets the definition. This change must be supported by evidence. The Board confirmed that a change in intention, in isolation, is not enough to support a transfer.

The issue arose from confusion over whether an entity transfer's property under development from inventory to investment property when there is evidence of a change in use that was not in the evidence explicitly stated in paragraph 57 of the standard. The list of evidence was therefore re-characterised as a non-exhaustive list of examples to help illustrate the principle. The examples were expanded to include assets under construction and development and not only transfers of completed properties.

The Board provided two options for transition.

1. Prospective application. Any impact from properties that are reclassified would be treated as an adjustment to opening retained earnings as at the date of initial application. There are also special disclosure requirement if this option is selected.
2. Retrospective application. This option can only be selected without the use of hindsight.

This amendment will be effective for annual periods beginning on or after 1 January 2018. Earlier application is permitted.

Annual Improvements to IFRS Standards 2014 – 2016 Cycle

Issue

The IASB issued Annual Improvements to IFRS Standards 2014 – 2016 Cycle on 8 December 2016. The changes are:

- *Retirement of short-term exemptions in IFRS 1*

The amendments deleted short-term exemptions covering transition provisions of IFRS 7, IAS 19, and IFRS 10. These transition provisions were available to entities for passed reporting periods and are therefore no longer applicable.

The amendments are effective for annual periods beginning on or after 1 January 2018.

- *Clarifying the scope of IFRS 12*

The amendment clarified that the disclosures requirement of IFRS 12 are applicable to interest in entities classified as held for sale except for summarised financial information (para B17 of IFRS 12). Previously, it was unclear whether all other IFRS 12 requirements were applicable for these interests.

The objective of IFRS 12 was provide information about nature of interests in other entities, risks associated with these interests, and the effect of these interests on financial statements. The Board noted that this objective is relevant to interests in other entities regardless of whether they are classified as held for sale.

These amendments should be applied retrospectively for annual periods beginning on or after 1 January 2017. An option to apply the amendments early is not necessary because disclosing additional information is not prohibited.

- *Clarifying measurement of investments under IAS 28*

IAS 28 allows venture capital organisations, mutual funds, unit trusts and similar entities to elect measuring their investments in associates or joint ventures at fair value through profit or loss (FVTPL). The Board clarified that this election should be made separately for each associate or joint venture at initial recognition.

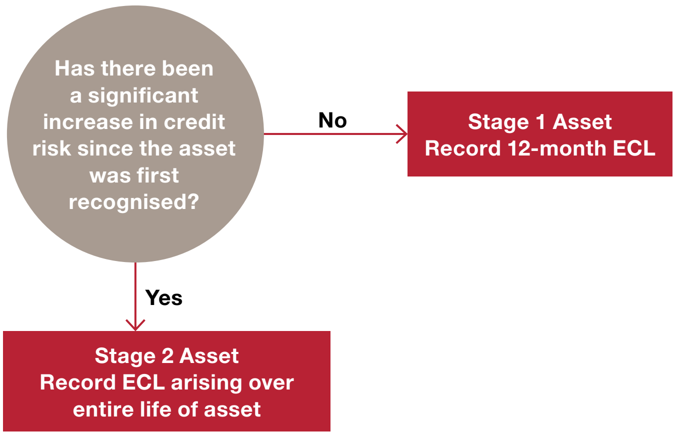
These amendments should be applied retrospectively for annual periods beginning on or after 1 January 2018. Early application is permitted.

Demystifying IFRS 9

This article explains how it's all relative for expected credit loss requirements under IFRS 9 until you fall off the cliff.

Credit risk management sits at the core of banking and IFRS 9's new expected credit loss (ECL) requirements go straight to the heart of this. This first column in our series looks at how to understand and apply IFRS 9's new impairment requirements for financial assets.

The fundamental question for determining ECL is whether there is a significant increase in credit risk since intial recognition of a financial asset. See the diagram below. The answer determines the size of the impairment loss allowance at the reporting date: it tells you whether the 'cliff effect' applies. No significant increase in credit risk since initial recognition and you have a 'stage 1' asset. Only a 12-month ECL are recognised, being expected losses associated with the risk of default in the next 12 months. If there has been a significant increase in credit risk, the asset is in 'stage 2' and *lifetime* ECL are booked. Lifetime ECL estimates the expected losses associated with the risk of default over the whole life of the instrument.



This could be a significantly bigger number for any asset with a life greater than 12 months. A bigger ECL would reduce reported profits and asset carrying amounts, with possible negative implications for regulatory capital.

Assessing a significant increase in credit risk is a relative test

The assessment of significant increase in risk is a *relative* measure. Banks are required to compare credit risk at the reporting date with credit risk at the date of initial recognition of the asset. This can lead to some strange effects. For example, a bank makes two similar loans to the same customer at different times when the credit risk of the customer is different. The credit rating of each loan is the same at the reporting date. The relative increase in credit risk since initial recognition for each loan will differ. Thus, one of those loans may be in stage 1 and the other could be in stage 2.

Credit risk management in banks is usually focused on credit risk at a point in time, not changes in credit risk over time. A bank may seek to use an 'absolute' level of credit risk at the reporting date when assessing significant increases in credit risk. All loans that are assessed to be more risky than a certain threshold credit risk rating are treated as being in stage 2.

This approach has its attractions: it is simpler to operationalise and avoids the need to track the initial credit risk of each loan. However, it can only be used if it is consistent with the requirement to identify significant increases in credit risk on a relative basis. The bank would need to identify groups of loans whose credit risk on initial recognition falls within a narrow band regardless of their date of initial recognition. The bank will also need to demonstrate that increases in credit risk within this narrow band do not represent a significant increase in credit risk, but increases in credit risk beyond this narrow band do represent a significant increase in credit risk. This is likely to be challenging.

A change in the risk of default is the key driver for a significant increase in credit risk

It is the change in the risk of default, or the probability of default (PD), that is important when considering whether there has been a significant increase in credit risk. The amount of future expected losses is irrelevant.

For example, the risk of default of a fully collateralised mortgage could have significantly increased since initial recognition because the borrower has lost their job. The mortgage will be in stage 2, even though the ECL may be minimal, as the bank has sufficient collateral.

Changes in 12-month PDs may be a reasonable approximation of changes in lifetime PDs

Assessments of significant increase in credit risk are based on changes in the risk of default over the life of the asset. However, regulators often focus on 12-month PD (that is, the risk of default over the next 12 months). Banks may use changes in 12-month PDs provided they are a reasonable approximation of the changes in lifetime PDs.

Banks may already have regulatory 12-month PDs, but these will generally need adjusting to meet the requirements of IFRS9.

What next?

Next month's column will cover more questions on significant increase in credit risk.

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