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ABU DHABI ACCOUNTABILITY AUTHORITY

ADAA IFRS DIGEST

IFRS news from ADAA, IASB, and the Accounting Profession

September 2019

مـعــاً نحـمي المــال العــام
Together Safeguarding Public Funds

WHAT'S NEW THIS MONTH

> **Auditing less complex entities**. IAASB hears your challenges!

> **Proposed amendment to IAS 12.** Deferred Tax related to assets and liabilities arising from a single transaction.

> **IFRS 16 'Leases'.** What are the consequences?

> **Transition from IBOR to ARR.** Major repercussions for the wealth and asset management industry.

> **IESBA - expected role and mind-set of professional accountants.** Time for a revised code of ethics.

> **Sustainability reporting.** Recent developments.

> **Ethical dilemma.** How to act professionally.

> On the back pages: **Back to Amortisation** and **Accounting policy disclosures,** insight from ADAA's Richard Wright.

NEWS IN DETAIL

> Auditing less complex entities.

The IAASB has issued a discussion paper to highlight the challenges of using ISAs in audits of less complex entities - and assess possible actions to address these challenges. It recognises the global call for action to address issues of complexity, length, understandability, scalability, and proportionality related to using the ISAs. The Discussion Paper explores how the IAASB, and others, could further support auditors working in increasingly evolving environments. More here.

> Proposed amendment to IAS 12.

The IASB proposes to amend IAS 12 'Income taxes' to clarify the accounting for deferred tax on particular transactions, such as leases and decommissioning obligations. There is currently no consistent approach to recognising deferred tax, reducing comparability. The Board is proposing amendments to require a company to recognise deferred tax for temporary differences that arise on such transactions. The proposed amendments would do so by narrowing the scope of the recognition exemption. Read more here and see the IASB briefing here.

> IFRS 16 'Leases'.

Under IFRS 16, lessees will need to recognise virtually all of their leases on the balance sheet by recording a right of use asset and a lease liability. While this 'gross up' in total assets and total liabilities is the most obvious impact of adopting IFRS 16, there are a number of less obvious impacts that adoption of IFRS 16 will have, since it intersects with other IFRSs. PWC has issued an "In depth" publication on the impact from IFRS 16 on entities applying IAS 12, IAS 16, IAS 21, IAS 36, IAS 37, IFRS 3, IFRS 8, and IFRS 9. Access the PDF here.

> Transition from IBOR to ARR.

This will cause major repercussions for the wealth and asset management industry referencing interest rate derivatives.

The new Alternative Reference Rates (ARRs) will be simpler than those pegged to the old IBORs. For example, they won't be transacted on a term structure or using indicative rates.

Instead, they will be linked to real, risk-free rates, making it easier to net down existing positions, swap and compare assets, and facilitate simultaneous cross-currency transactions. See more from EY here.

> IESBA - expected role and mind-set of professional accountants.

The proposed revisions to the code of ethics may strengthen the application of professional scepticism practiced by all professional accountants for all professional activities not reserved for audit use only. The proposal includes materials promoting integrity, objectivity and professional behaviour. The code of ethics requires professional accountants to have an inquiring mind-set and to be inquisitive, to conduct necessary investigation and assessment to reach an informed decision. Details here.

> Ethical dilemma.

Being a professional accountant requires much more than professional competence in technical matters. For an accountant to be a trusted advisor or business partner, professional ethics is fundamental. Professional integrity should be valued for bringing credibility to decision making and safeguarding the interests of stakeholders.

The Royal Netherlands Institute of Chartered Accountants (NBA) has established the "moral intervision model" which is an action-based approach comprising of questions and steps to help accountants reflect on the ethical issues they face at work. More about the model here.

> Sustainability reporting.

Deloitte provides an update on developments in sustainability reporting. As well as reports by the CFA Institute and the Carbon Disclosure Project, the Sustainable Stock Exchanges (SSE) has announced that the Abu Dhabi Securities Exchange (ADX) has issued environmental, social and governance (ESG) disclosure guidelines for listed companies. The guidance document provides companies with a set of 31 KPIs aligned with the exchange's strategy which is designed to support economic growth, while providing a sustainable trading environment and encouraging the business community to adopt societal sustainability practices.

BACK TO AMORTISATION!

> Background

In the film 'Back to the Future III', Doc Brown says: "Your future hasn't been written yet. No one's has. Your future is whatever you make it. So make it a good one." Following the post-implementation review of IFRS 3 'Business Combinations', the IASB currently has a project to review the accounting treatment of goodwill which might see a return to 2004 to improve the future of accounting. At the recent IFIAR conference in Paris, the IASB noted that we can expect a discussion paper or exposure draft in H2 2019.

When IFRS 3 was introduced in 2004 the IASB abolished the amortisation of goodwill, relying instead on the impairment-only approach. Goodwill in an acquisition is measured as the purchase price less all identifiable assets and liabilities. Impairment is only recognized if the future expected cash flows from the underlying assets does not support the recoverable amount.

This had the unfortunate consequence that managers that were responsible for making acquisitions which increased revenue and EPS (and bonuses), were now also responsible for judging the success of the acquisition, by assessing whether goodwill was impaired. And forecasts of synergies and future cash flows are inherently risky and easy to manipulate.

> Why the rethink?

IASB chair Hans Hoogervorst addressed goodwill in a speech (link) in Japan in August 2018 and highlighted the board's concerns:

- The annual impairment test is both costly and subjective.
- Often, the projections of future cash flows from cash generating units tend to be on the rosy side.
- Impairment losses therefore tend to be identified too late.
- Goodwill tends to be shielded by a 'headroom' of internally generated goodwill.

"Given that IFRS 3 relies completely on the impairment test to ensure that goodwill really exists, this is a far from satisfactory situation. The risk is that goodwill just keeps on accumulating over time even when the economics do not justify this. In such cases, the balance sheet may give an overly optimistic representation of a company's financial health."

> The extent of the problem

In 2009, just after the global financial crisis, a study was published which looked at the goodwill impairments made by the largest 50 US banks. In the run-up to the crisis, the financial sector had seen a spree of acquisitions. Of the 50 banks studied, 48 had made an acquisition, recording a total of $270bn of goodwill. "Despite the huge falls in their market value, which meant that 36 of the 50 were trading at steep discounts to net assets at the time of the survey, only 15 had impaired goodwill. Those that didn't included some of America's largest banks, such as Bank of America, JPMorgan and Wells Fargo. Collectively, these institutions had not written down goodwill worth $190bn on their books." (link). Since 2007, the total goodwill on the balance sheets of S&P 500 companies has increased from $1.8 trillion to $2.9 trillion in 2016.

Similarly, in 2013, the European Securities and Markets Authority (ESMA) published a damning report dealing with goodwill and related impairment in the financial statements of listed European companies. ESMA found that of 235 European companies with a combined total €800bn of goodwill on their balance sheets in 2011, only 5 per cent of that was shown as impaired. (link).

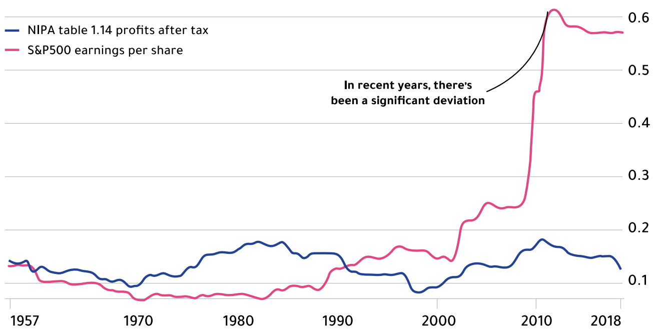
> Quality of corporate earnings and the profit and bonus culture

Recent commercial practice regarding remuneration and bonuses has provided incentives to overstate profits to boost short-term changes in earnings per share or return on equity. So how might the quality of profits (including not impairing goodwill) published by Companies be judged?

In a recent article [(link)](#), economist Andrew Smithers compared the published profits of US Companies with those in the National Accounts (which are theoretically more reliable). The chart below highlights the divergence in recent years which suggests Companies are now overstating profits and understating losses more than ever. Partly due to goodwill being maintained for too long in the balance sheet.

The growing volatility of US accounts

Standard Deviation in Annual Log Changes over Past 10 Years



Source: Andrew Smithers

> Why was amortisation scrapped?

Hans noted that there were many good reasons why the IASB decided to get rid of amortisation in 2004:

"The information value of amortisation is very low as it is impossible to determine objectively the timeline over which amortisation should occur.

Goodwill is an asset with indefinite life and in some cases its value might not decrease over time.

We also know that many investors will ignore amortisation and will immediately add it back in their projections. Given our efforts to push back on non-GAAP measurements, this would not be a great development.

Finally, any major accounting change needs to pass a clear cost-benefit analysis. It is not immediately clear that re-introduction of amortisation would clear that hurdle."

> What next?

Both the amortisation model, and the impairment model have drawbacks. Hans cautions that it is far from a foregone conclusion that the IASB will decide to reintroduce the concept of amortisation. However, he goes on to say

"whatever the outcome of this exercise will be, the discussion paper should serve to make our stakeholders better aware of the shortcomings of the impairment-only approach. It may be that there is no better alternative, but in that case we should accept the current shortcomings of IFRS 3 with our eyes wide open. Should the discussion paper lead to better awareness of the possible pitfalls of current accounting for goodwill, this would in itself be a positive development."

> Final thoughts

In the January back page article, we featured Carillion the major UK multinational construction and facilities management company that was put into compulsory liquidation. Carillion did many transactions in the years before its collapse in January 2018, some of which were bad deals. However, even until just a few months before its insolvency, the group's directors continued to assert that none of the £1.6bn of goodwill they had recorded was impaired!

Executives don't like to impair assets, especially if they bought them in the first place. Perhaps we will see a return of amortisation and the start of a more cautious era for financial reporting. In Back to the Future II, Doc Brown says: "Time traveling is just too dangerous", let's hope the IASB ensure we head into the future with a more sensible approach to goodwill.

THE END OF BOILER PLATE ACCOUNTING POLICIES?

> Boiler plate issue

In August, the IASB issued an exposure draft 'Disclosure of Accounting Policies (Proposed amendments to IAS 1 and IFRS Practice Statement 2)' which if adopted, would see an end to long winded, irrelevant, boiler plate accounting policies.

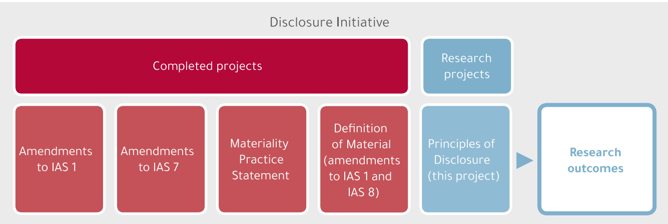
> Background

One of the IASBs major projects is the Disclosure initiative.

The board received feedback from stakeholders about three problems of disclosures:

- Not enough relevant information;
- Too much irrelevant information;
- Ineffective communication of the information provided.

Several parts of the project have already been completed as shown below:



One of the findings from the Principles of Disclosure project, was the addition of a new project on accounting policy disclosures to the Board's agenda.

"Stakeholders expressed support for the board developing guidance to help preparers decide which accounting policies to disclose. Most users of financial statements commented that accounting policy disclosures are seldom useful and could be improved. Users said that accounting policy disclosures are useful only when they provide insight into how an entity has exercised judgement in selecting and applying accounting policies."

> The exposure draft

From the IASB press release: IAS 1 requires companies to disclose their 'significant' accounting policies. The Board is proposing to replace the reference to 'significant' with a requirement to disclose 'material' accounting policies to clarify the threshold for disclosing information.

The proposals state that information about an accounting policy is material if, when considered together with other information included in a company's financial statements, it can influence financial statement users' decisions about the company. The Board is also proposing to add guidance to IAS 1 to help companies understand what makes an accounting policy material.

The other main changes are:

> Paragraph 117A

Accounting policies that relate to immaterial transactions are themselves immaterial and need not be disclosed.

> Paragraph 117B

An accounting policy is material if information about that accounting policy is needed to understand other material information in the financial statements.

For example, an entity is likely to consider an accounting policy to be material to its financial statements if that accounting policy relates to material transactions, other events or conditions **AND**:

(a) was changed during the reporting period because the entity was required to or chose to change its policy and this change resulted in a material change to the amounts included in the financial statements;

(b) was chosen from one or more alternatives in an IFRS Standard, for example, the option to measure investment property at either historical cost or fair value;

(c) was developed in accordance with IAS 8 in the absence of an IFRS Standard that specifically applies;

(d) relates to an area for which an entity is required to make significant judgements or assumptions in applying an accounting policy and discloses those judgements or assumptions in accordance with IAS 1; or

(e) applies the requirements of an IFRS Standard in a way that reflects the entity's specific circumstances, for example, by explaining how the requirements of a Standard are applied to the facts and circumstances of a material class of transactions, other events or conditions.

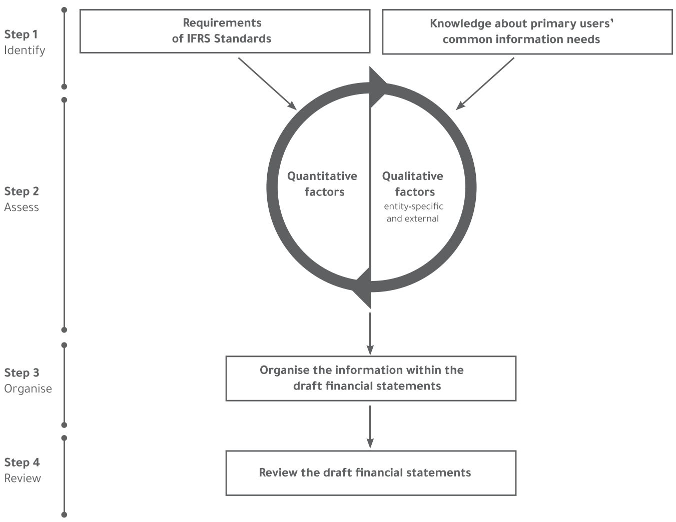
> Paragraph 117C

Information about accounting policies that focuses on how an entity has applied the requirements in IFRS Standards to its own circumstances provides entity-specific information that is more useful to users of financial statements than standardised descriptions or information that only duplicates the recognition or measurement requirements of IFRS Standards.

> Amendments to IFRS Practice Statement 2 'Making Materiality Judgements'

IFRS Practice Statement 2 is updated by adding further explanations and examples to help companies apply the concept of materiality in making decisions about accounting policy disclosures when using the four step materiality process:

Diagram 3.1–the four-step materiality process



Two examples are added. Example S is about an entity that operates in the telecommunications industry - making materiality judgements and focusing on entity specific information while avoiding standardised ('boiler plate') accounting policy disclosures. Example T deals with accounting policies that do not include entity specific information and only duplicate requirements in IFRS Standards.

This guidance will stop the copy and paste from accounting standards and instead, promote useful entity specific accounting policies, that describe where actual accounting policy choices have been made e.g. fair value or cost in IAS 40.

> Next steps

ADAA has published several articles about boiler plate accounting policies and disclosures, and the disclosure initiative is welcomed.

Whilst comments are requested by 29 November 2019, and changes to IAS 1 should follow later, there is nothing to stop preparers from incorporating the spirit of these improvements in the 2019 financial statements.

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