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ABU DHABI ACCOUNTABILITY AUTHORITY

ADAA IFRS DIGEST

IFRS news from ADAA, IASB, and the Accounting Profession

November 2019

مـعـاً نحـمي الـمـال العـام
Together Safeguarding Public Funds

NEWS THIS MONTH

> **Interest Rate Benchmark Reform.** Summary of IASB's amendments.

> **ESMA enforcement priorities.** The European regulator issues guidance.

> **The future of finance.** A look into the crystal ball.

> **Annual Global CEO Outlook.** Resilience and agility.

> **Building Data Science and Analytics Capabilities in Finance and Accounting.** Data is the new oil.

> **IAASB Achievements.** Summarising the Board's output from 2016-2019.

> **Revised Education Standards.** ICT and professional scepticism.

> **IFRS Interpretations.** New biannual compilation.

> **CFO Survey.** Persistent uncertainty takes its toll.

IN DEPTH

> **Non gap measures.** Earnings before bad stuff.

> **IFRS 9 structure, challenges, and focus on impairment:** An insight from ADAA's Fatema Lari.

NEWS IN DETAIL

> Interest Rate Benchmark Reform. Deloitte's publication covers the recent amendments to IFRS 9, IAS 39, and IFRS 7 published by the IASB. The amendments will affect entities that apply the hedge accounting requirements of IFRS 9 or IAS 39 to hedging relationships affected by the interest rate benchmark reform. Entities will apply the relevant requirements assuming that the interest rate benchmark is not altered as a result of the reform and the amendments are not intended to provide relief from any other consequences arising from the reform.

> ESMA enforcement priorities. The European Securities and Markets Authority (ESMA) has published its priorities for 2019 annual financial reports of listed companies:

- IFRS 16 Leases: the lease term and the discount rate.
- Improvements to standards that became applicable in 2018 (expected credit losses, and credit risk in IFRS 9, assumptions and judgements in IFRS 15).
- The application of IAS 12 Income taxes regarding deferred tax assets arising from unused tax losses.

ESMA will also focus on Key non-financial information issues and Alternative Performance Measures. Read more here.

> The future of finance. PwC and ACCA conducted research with leading finance professionals into the future of the finance function including disruptive technology. The research was based around six hypotheses that represent differing views on the future finance function, listed in order of likelihood:

- Accessible, trusted data will drive real-time, customer-centric decision making.
- Trusted data will be open and accessible across the organisation.
- Finance teams will spend all of their time on generating insights.
- Traditional finance roles will disappear. New roles, skills and career paths will be needed.
- The finance 'function' will be virtual.
- The traditional CFO role will be replaced by roles such as chief operating officer and chief strategy officer.

> Annual Global CEO Outlook. KPMG ran a global survey of 1,300 CEO's in some of the largest organisations to discuss how they are confronting long-held market orthodoxies and assumptions that govern decision-making. A key finding was that 67% of CEOs say that acting with agility is the new currency of business and being too slow risks bankruptcy. 84% of the CEOs said they are actively transforming their leadership team to build resilience so organisations can be comfortable disrupting their business models if they want to continue to grow (link).

> Building Data Science and Analytics Capabilities in Finance and Accounting. A strong finance and accounting background is no longer sufficient to become a value-add business partner over the long term. That was the message from IFAC's Professional Accountants in Business Committee which is looking at the finance and accounting professional role in data science and analytics. The critical aspects of data science that are needed for accountants to deliver insight and foresight are: statistics, data & data applications, and business domain. Details here.

> IAASB Achievements. The IAASB's report 'Foundation for the Future' summarises the Board's achievements from 2016 to 2019 whilst chaired by Prof. Arnold Schilder. In line with their strategy, the IAASB's activities have focused on enhancing audit quality and addressing engagements other than audits of financial statements.

> Revised Education Standards. The IAESB has released 4 revised International Education Standards (link) addressing learning and development for ICT and professional scepticism. The revised standards support the continued enhancement of quality financial reporting as the disruptive potential for ICT increases and the importance of demonstrating professional scepticism is heightened.

> IFRS Interpretations. The IFRS Foundation's first biannual 'Compilation of Agenda Decisions' brings together agenda decisions published by the IFRS Interpretations Committee from Jan to Sep 2019. The agenda decisions are organised by the IFRS Standard to which they relate. The document is intended to make the already published work of the Committee more accessible. Future compilations will be published twice a year, in April and October.

> CFO Survey. Deloitte's quarterly survey of CFOs of major companies in the UK gauges attitudes to valuations, risk and financing. Key findings:

- More CFOs are prioritising cost reduction than in late 2009, when the economy was emerging from recession.
- Brexit remains the top concern for CFOs, and concern about slowing growth in the UK and euro area is rising.
- 70% of CFOs expect to reduce hiring in the next 12 months and just 3% expect to raise it.

Non-GAAP measures

EBBS is an acronym for "Earnings before bad stuff". A humorous take on performance measures created by the management of a company. Financial reporting based on generally accepted accounting principles (GAAP) is vital for understanding a company's financial performance, financial position, and cash flows. GAAP measures are defined in the accounting standards. IAS 1 requires disclosure of profit and loss, and total other comprehensive income.

However, companies also like to report tailored, adjusted measures that better suit the entity and management's views. These adjusted measures are known as non-gaap measures or alternative performance measures (APMs) and include operating income, EBITDA, adjusted net income, free cash flow, and adjusted earnings per share. APMs are not defined or specified under the current requirements of IFRS.

Regulations vary from country to country, but the general rule for APMs is that they should not have a greater prominence than the statutory measure, and they should be reconciled to the statutory measure. In the US, rules are issued by the SEC, and in Europe by ESMA. More details here

Most companies now use APMs. Management like to report them, as this is how they manage the business. Non-GAAP financial measures are considered useful by many investors and analysts who believe that GAAP financial measures do not adequately capture a company's value. Non-GAAP financial measures typically eliminate items deemed temporary, outside the ordinary course of business, or irrelevant by management and give a clearer picture of the underlying business.

Real estate entities present adjusted profit numbers that strip out property valuation gains. This gives a clearer picture of how well the company is using the assets to generate rents, without being swamped by the (often much larger) valuation gains which can be cyclical and based on factors outside of management control. Some companies provide a value of indebtedness which records operating lease commitments (pre IFRS 16) to give a better understanding of liabilities.

In its latest annual report, Marks and Spencer (M&S) discusses its APMs in the accounting policy section. M&S believe that APMs provide stakeholders with additional helpful information on the performance of the business. These APMs are consistent with how the business performance is planned and reported within the internal management reporting to the Board.

Some of adjusting items disclosed include:

> Charges from the strategic programme in relation to the review of the UK store estate.

> Significant restructuring costs from strategy changes.

> Impairment charges and provisions.

> Charges arising from the write-off of assets and other property charges.

> Significant costs arising from establishing a new joint venture with Ocado.

> Provision recognised by M&S Bank for the cost of providing redress to customers in respect of possible mis-selling of M&S Bank financial products.

The adjustments to operating profit totalled £439m in 2019 and £514m in 2018. When General Electric reported its results in January 2019, it reported a continuing loss per share of $2.43 yet "adjusted" earnings per share of $0.65.

> Thomas Cook

Difficulties arise when the APMs are misused or create confusion for readers of the financial statements. A company has flexibility in which non-GAAP financial measures it chooses to report, and how it calculates such measures. Although non-GAAP financial measures are commonly used, they are not standardised and therefore may not be comparable from one industry to another. Some companies use the adjusted measures more frequently in the management commentary, or give greater prominence in press releases.

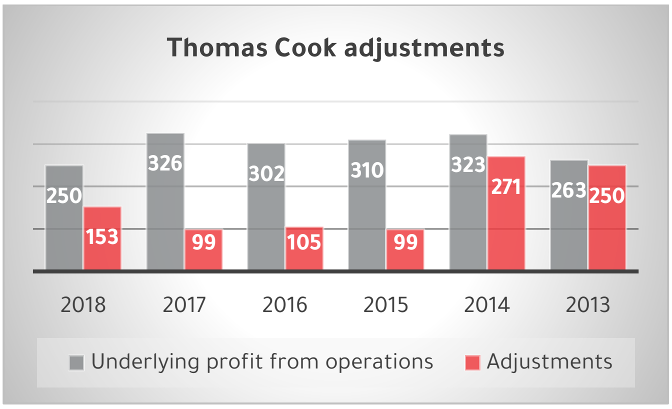
Thomas Cook, formed in 1841, was the world's oldest travel firm. Despite reporting revenues of over £9.5bn it went into compulsory liquidation on 23 September sending shockwaves through the travel industry and leaving thousands of holiday makers stranded. The business model used by Thomas Cook, historically relied heavily on physical high street travel agents. Technology has disrupted this model and also consumers now spend less on mass market package holidays.

In its 2018 financial statements Thomas Cook stripped out £153m of costs from its profit from operations, to arrive at underlying profit of £250m (see diagram on next page). Some of adjusting items disclosed include:

> New Operating Model implementation costs.

> Restructuring costs.
> Onerous leases and store closures.
> Investment in business development and start-up costs.
> Impairment of assets.

In the key audit matters section of the audit report, the auditors disclosed that they had communicated to the Audit Committee that they had "strongly recommended to management that they strengthen the process over the identification and approval of separately disclosed items."



Whilst there is no evidence these adjustments were not appropriate, the Financial Reporting Council have said "In light of recent developments at Thomas Cook we are considering whether there is any case for investigation and enforcement action as a matter of urgency and in cooperation with the Insolvency Service."

> What next?

Non-gaap measures have been included in the IASBs primary financial statements (PFS) project (link). The Chair of the IASB, Hans Hoogervorst, discussed APMs at the IFRS Foundation Conference 2019 in London:

"Non-GAAP measures tend to paint a very rosy picture of a company's performance, almost always showing a result that is better than the official IFRS numbers. A study in the US a few years back showed that around 9 out of 10 companies in the S&P 500 disclose non-GAAP metrics and 8 out of 10 showed increased net income. The 'core earnings' metric was on average 30% higher than GAAP earnings.

The PFS project will introduce greater transparency and discipline to the use of subtotals not defined in IFRS. We aim to improve transparency around management performance measures (MPMs) by requiring companies to locate MPMs and the information explaining these measures within a single note in the financial statements. This will make it much easier for investors to find the information. Currently, they often need to search around for this information both in and outside the annual report.

Some may worry that bringing MPMs into the financial statements enhances the status of non-GAAP. However, the presentation of the MPM's will be subject to much of the discipline that many market regulators around the world already require. Management will need to explain how the MPM is calculated and why it is important. Consistent recognition and reporting will be required from one period to another, and if a company decides to change its performance measures, it will have to explain why.

Discipline also comes from requiring companies to provide a reconciliation between their own performance measures and the closest IFRS-defined subtotal. This will help investors to better understand how the company arrived at a particular number, and perhaps more interestingly, why management apparently thinks that an IFRS subtotal was insufficiently clear about the company's performance.

Moreover, by bringing the MPMs into the notes, they will have to be in line with the 'fair presentation' requirements set out in IAS 1. This should help weed out MPMs that are clearly unbalanced. The MPMs will also be brought into the scope of audit, something which will further strengthen discipline. While we recognise that MPMs are here to stay, we see our role as helping investors in their analysis by shining a brighter light on them."

The SEC continues to focus on noncompliant use of non-GAAP financial measures. At the end of 2018, it brought an enforcement action against ADT Inc. The SEC found that ADT disclosed non-GAAP financial measures in two earnings releases without presenting the most directly comparable GAAP figure with "equal or greater prominence" as required by regulations.

> Conclusion

Whilst adjusted measures can undoubtedly be useful for preparers and users of the accounts, the output from the IASB will be welcome to ensure the numbers are not just wishful thinking.

IFRS 9 structure, challenges, and focus on impairment: insight from ADAA's Fatema Lari.

Everyone holds financial instruments, whether it's the less complex trade receivable in a small grocery store, or the more complex loans and advances and customer deposits in the highly regulated banking sector. But whether simple or complex, they need to be recognised, classified, and measured according to the now-effective IFRS 9: Financial Instruments.

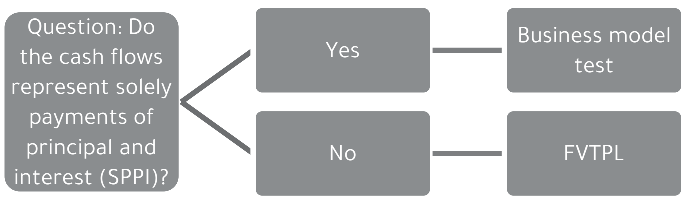
> Classification and measurement

Financial instruments measured at amortised cost or Fair Value through Other Comprehensive Income (FVOCI) are initially recognised at their fair value in addition to transaction costs (cost directly attributable to the acquisition of the asset/issuance of the liability). The instruments measured at fair value through profit or loss (FVTPL) are initially recognised at fair value only.
For financial assets, unlike IAS 39, IFRS 9 has merged the classification and measurement models as shown below:

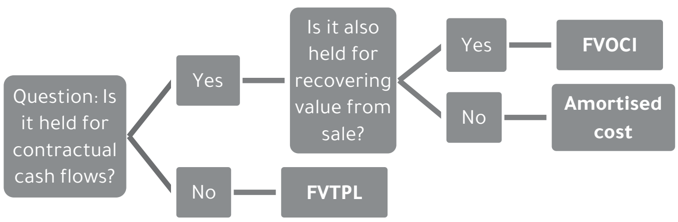
IFRS 9	IAS 39	
Class. and Measurement	**Classification**	**Measurement**
Amortised cost	Loans and receivables	Amortised cost
FVTPL	FVTPL	FVTPL
FVOCI	Available for sale	FVOCI
	Held to maturity	Amortised cost

Now, how is the classification determined under IFRS 9?
By running two tests:

1. The cash flow test



2. The business model test



For financial liabilities, all are to be classified, therefore measured at, amortised cost, except for the following conditions where they should be classified at FVTPL:

- Derivatives, except for financial guarantees and effective hedging instruments.
- If it will resolve an accounting mismatch.

Although IFRS 9 allows reclassification of financial assets if the business model changes, financial liabilities cannot be reclassified after initial recognition.

> Impairment

IAS 39, required providing for credit losses based on the "incurred loss model", to recognise loss after default. This is too late in the credit cycle, and was a major criticism of IAS 39 after the 2008 financial crisis. IFRS 9 eliminates the need for impairing instruments held at fair value, but requires providing using the "expected credit loss model" for instruments held at amortised cost by estimating future default according to the "expected" increase in credit risk. How to do that? IFRS 9 provides two approaches (we will ignore the credit adjusted approach):

The simplified approach: limited to trade receivables, contract assets, and lease receivables. This approach uses historical data to estimate future default rates according to days past due. Refer to the October 2018 Digest for a detailed discussion of the simplified approach.

The general approach: used for all financial assets except those applying the simplified approach. This approach is applied by staging the impairment as follows:

1. Stage 1: provide the ECL for the coming 12 months for all financial assets.
2. Stage 2: if credit risk has increased significantly, provide lifetime ECL. Interest income is recognised on the gross carrying amount. (see *Ongoing challenges: Forbearance).*
3. Stage 3: if there is objective evidence of default, then provide lifetime ECL, interest income is recognised on a net basis, i.e. calculated based on the gross carrying amount of the financial asset less ECL.

The general approach is more complex, and is for more complex financial assets. Therefore, more complex instruments such as loans and advances, which naturally carry higher amount of risk, needs a future oriented provision calculator, instead of the historical based simplified approach.

Also, it is not only IFRS that scrutinises calculation of provisions on these complex instruments. Some industries, such as banking, have regulators providing their own benchmarks. This makes the future oriented provision calculations more complex as they are associated with credit risk measures, that are not all straight forward and objective. (see *Ongoing challenges)*.

IFRS 9 allows reversal of impairment losses recognised in prior years, by recognising an impairment gain in the financial statements if indicators exist.

> Adoption challenges

- IFRS 9 needs a robust business model, developed with a thorough understanding of all the financial instruments the entity holds or can hold in the future.
- A robust model is only possible with a robust infrastructure. A robust system is required to process ECL calculations on large amounts of data periodically.
- Extra cost and time of rendering the IT infrastructure and developing the business model. Other costs associated with the implementation are more complex credit risk assessment tools and higher fees charged by auditors for the assessment of the business model.
- Adoption of IFRS 9 increased allowances due to the ECL resulting in a decrease in profits.
- Additionally, although IFRS 9 is simpler than IAS 39, it adds increased volatility in the profit and loss, resulting from the classification requirement where more financial assets are accounted through FVTPL, especially for those holding financial assets other than plain vanilla loans and receivables.

> Ongoing challenges

- The standard is certainly more forward looking, but it comes at a cost of more subjectivity in the information provided to the users of financial statements. There are more estimates incorporated into the model, compared to IAS 39. In both classification and measurement of the instruments, we now see management's input more than ever before, resulting in increased subjectivity of the information.

  And that is exactly how principle based standards are. It puts management to work to create a model best suited to the organisation, but within a specified framework. But such model needs both historical and risk data as a foundation for its success. That is for both a general approach and simplified approach to impairment.

- Forbearance: when an issuer of financial asset grants its customer forbearance measures (concessions given due to financial difficulties), is it a transition from stage 1 to stage 2? This issue was the subject of a 2019 ESMA decision. Forbearance is a significant increase in credit risk since initial recognition that requires recognising lifetime ECL.

  Therefore, the business model should include a determinant that any forbearance measure will automatically classify the financial asset at stage 2.

- Disclosures have varied in quality in 2018. Some entities' disclosures were more detailed than others. The aim is comparability, which has been difficult to maintain across even the same industry because IFRS 9 is both principles based and heavily dependent on estimates and judgements by management.

  The UK's FRC conducted a thematic review of IFRS 9 disclosures and published its findings in October 2019. It noted the following areas for improvement:

  1. Credit risk management policies, specifically the analysis of financial assets credit risk profile;
  2. Qualitative and quantitative disclosures about ECL, specifically the factors determining what constitutes significant increase in credit risk;
  3. Details of how the simplified approach to impairment is applied; and
  4. Details of the business model used to classify the financial assets.

> Final thoughts

Hedge accounting, also covered by IFRS 9, is not addressed in this article. After the first year of mandatory adoption, the business model will have to undergo changes to improve the application of the principles underlying the standard. Improved disclosures are also a future focus.

When information is forward looking, it is implied that it involves various judgements. Judgements change as we are provided with more and better information. So IFRS 9 is a journey, and initial adoption is just the start of it.

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