IFRS news

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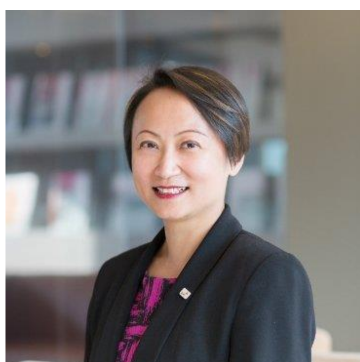

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Cracking the cryptocurrency code; or what is a 'bitcoin' anyway?

Yvonne Kam, IFRS Partner, explains the latest trend of cryptocurrencies.

Cryptocurrency is virtual currency which seems to be created out of thin air. It is increasingly used IRL (in real life) to pay for goods and services and for investment purposes. Transaction volume is growing exponentially and values are volatile. There is no specific guidance in IFRS or US GAAP on accounting for cryptocurrencies, despite accelerating use.

What is a cryptocurrency?

A cryptocurrency is a form of exchange that does not exist in physical form but only digitally. It is not linked to any physical currency, nor is it backed by any government, central bank, legal entity, underlying asset or commodity. It may be quoted on an exchange against other currencies. The most commonly known example of a cryptocurrency is the 'Bitcoin'.

How might bitcoins be accounted for?

Asset		Explanation
Cash	X	Cryptocurrencies are not issued or backed by any government or state.
Cash equivalents	X	Volatile, hence there is a significant risk of changes in value.
Financial instruments	X	Does not give the holder a contractual right or obligation to receive cash or another financial asset
PPE or Investment Property	X	Has no physical form, certainly not land and buildings.
Inventory	?	Inventories do not need to be in a physical form, but do need to be held for sale in the ordinary course of business. However, cryptocurrencies may not be traded frequently enough such that trading activity would be an entity's 'ordinary course of business. Bitcoins would fail the definition of inventory unless this test is met.
Intangible	✓	Cryptocurrencies appear to meet the definition of an intangible asset: identifiable as can be sold, exchanged or transferred individually; not cash and non-monetary asset; have no physical form.

Is bitcoin really an intangible asset?

Intangible assets, say patents or brand names, have traditionally been assets held for use in the production process. The primary objective is to generate revenue from the entity's ordinary course of business.

Cryptocurrencies are used to pay for goods and services, to incentivize employees and for investment purposes. The use of an intangible asset feels very different from the use of a cryptocurrency.

Fair value measurement feels like the most relevant measurement basis for a cryptocurrency because it's being used as a currency-equivalent or alternative investment vehicle.

An intangible asset can be measured at fair value but only if there is an active market. Fair value movements must be recognized in Other Comprehensive Income (OCI).

What's next?

Cryptocurrencies are growing and are volatile. Shareholders and other lenders exposed to companies that hold cryptocurrencies need to know about them. New guidance may need to be developed to avoid diversity in practice and provide meaningful information. Until we have new guidance, disclosure is key to explaining how cryptocurrency is classified and measured.

***Manuel Pereyra, IFRS specialist from PwC ACS Venezuela, examines the practical implications of IFRIC rejections related to IAS 29,* Financial reporting in hyperinflationary economies**

IFRIC Rejections in short – IAS 29

Looking for an answer? Maybe it was already addressed by the experts

The Interpretations Committee (IC) regularly considers anywhere up to 20 issues at its periodic meetings. A very small percentage of the issues discussed result in an interpretation. Many issues are rejected; some go on to become an improvement or a narrow scope amendment. The issues that are not taken on to the agenda end up as 'IFRIC rejections', known in the accounting trade as 'not an IFRIC' or NIFRICs. The NIFRICs are codified (since 2002) and included in the 'green book' of standards published by the IASB although they technically have no standing in the authoritative literature. This series covers what you need to know about issues that have been 'rejected' by the IC. We go standard by standard and continue with IAS 29 as per below.

IAS 29 only applies when an entity's functional currency is that of a hyperinflationary economy. Its use is limited, therefore only two issues have been rejected by the IC.

November 2002 – Various issues

The IC discussed various issues in hyperinflation accounting to provide recommendations to the IASB Improvements and Convergence projects. The IASB withdrew IAS 15, *Information Reflecting the Effects of Changing Prices* with effect from 1 January 2005.

The IC provided input to the Board on:

- Determining when an economy is hyperinflationary
- Presentation of comparative figures
- The definition of a general price index

Some issues were addressed in IFRIC 7 - *Applying the restatement approach under IAS 29 Financial reporting in hyper-inflationary economies.*

January 2014 - Applicability of the concept of financial capital maintenance defined in terms of constant purchasing power units.

The IC considered two questions on the concept of financial capital maintenance:

- If an entity is permitted to use the financial capital maintenance concept, defined in the framework in terms of constant purchasing power units when the entity's functional currency is not the currency of a Hyperinflationary economy as described in IAS 29 and;
- if the above is permitted, whether the entity needs to apply IAS 29 to its financial statements.

The IC confirmed that the guidance in the conceptual framework should only be used in the development of an accounting policy when no standard specifically applies. Outreach indicated that the issues are not widespread and the IC decided not to add the issues to its agenda.

Ruth Preedy, IFRS Business Combinations specialist, explains what IFRS reporters should do until the IASB finalises the definition of a business.

The Twilight Zone

It's a business, it's an asset… no wait, it's a GAAP difference

The twilight zone is 'a situation or conceptual area that is characterized by being undefined, intermediate, or mysterious.' In the world of accounting, it's the mysterious space between the FASB and the IASB on a 'converged' standard.

Convergence is a blast from the past for most accountants but there are a few standards that are still holding on. One of those standards is business combinations. However, the Boards are working at different speeds to finalise changes following the post implementation reviews.

Feedback received by the Boards identified the definition of a business as too broad; resulting in too many transactions qualifying as business combinations. The FASB, moving quickly, finalised amendments earlier this year.

The IASB is playing 'follow the leader' and has issued an exposure draft largely following the FASB's direction. The IASB discussed the comment letters at the February Board meeting and it looking like months before we see final amendments.

What's new?

The main change proposed is a screening rule added as a simplification. An acquisition will be an asset transaction if substantially all of the fair value of gross assets acquired is concentrated in a single asset (or a group of similar assets). More transactions will be asset acquisitions, especially in the pharmaceutical and oil and gas industries.

The amendment also clarifies that to be a business, the transaction must have an input and a substantive process and add guidance to help decide what a substantive process is.

The IASB now has a dilemma: take on board the feedback that the screen should not be a rule and give up on convergence; or remain with a converged standard and ignore respondent feedback on the screen. Deliberations are likely to take some time.

US GAAP adoption

The FASB definition is available for early adoption; the amendments can be applied to transactions occurring before the guidance was issued (January 5, 2017) as long as the applicable financial statements have not been issued. Early signs are that there has been enthusiastic take up for the early adoption option.

Can I early adopt the FASB amendment (or the IASB proposals) if I am an IFRS reporter?

Sadly, no. The early direction of travel seems very similar but it is too soon yet. IFRS reporters must follow IFRS and there is no IAS 8 option available because the requirements of IFRS are clear. An exposure draft is not authoritative, the current standard must be followed. We will have a significant period of time where there will be an IFRS to US GAAP difference on the definition of a business.

IFRS 3 breaking news from the February Board meeting.

The staff presented a summary of the 80 comment letters received. No decisions were made. The comment letters were broadly supportive, however, a number of respondents did not agree with the screening test being a rule and suggested this was included as an indication or a rebuttable presumption. Respondents also proposed that the guidance remained converged with the US standard.

For more detail on the FASB amendment:

FASB finalises a new definition of a business

Navigating the maze of IFRS 15 transition

Katie Woods, Revenue expert, guides us through the maze of IFRS 15 transition and makes sure we stay on track.

You have probably worked through the IFRS 15 5-step approach and got to grips with terms such as 'performance obligation' and 'control'. But have you navigated the maze of how to transition from existing GAAP (IAS 18, *Revenue*, and IAS 11, *Construction contracts*) to the new standard? IFRS 15 is applicable for periods beginning on or after 1 January 2018, with early application permitted. There are two transition approaches:

Approach	Application	Comparatives
Full retrospective	The financial statements are presented as if IFRS 15 has always been applied.	Comparatives (including the opening balance sheet) are restated.
Modified retrospective	The financial statements are retrospectively adjusted but the cumulative impact is recognised at the date of initial application (1 January 2018 for calendar year ends.)	Comparatives are not restated and are presented using existing GAAP.

Transition decisions do not stop there. The standard provides three practical expedients to simplify transition for contracts that are completed. A completed contract is a contract where an entity has transferred all of the goods or services identified in accordance with existing GAAP. The expedients differ depending on whether an entity has chosen full or modified transition. Entities need to apply any elected expedients consistently to all contracts. Entities should also disclose the expedients that have been applied.

Expedient 1: Completed contracts

Full retrospective:

An entity does not need to restate any contracts that are completed before the beginning of the comparative period (option 1) and/or that begin and end in the same annual reporting period (option 2). For example, an entity with a calendar year end would not restate any contracts that completed before 1 January 2017 when applying option 1 only.

Modified retrospective:

An entity does not need to restate any contracts that are completed before the date of initial application.

Expedient 2: Variable consideration hindsight

This is only available if following the full retrospective approach. An entity may use the transaction price at the date the contract was completed during the comparative period for a contract that:

- has not used the completed contract expedient;
- completed in the comparative period, and
- includes variable consideration.

Expedient 3: Contract modification

This expedient is available under both approaches. The aggregate impact of all modifications are accounted for at the same time to determine the contract price and identity the performance obligations.

Identifying completed contracts

Entities need to determine if there are any promises to customers outstanding at the end of the comparative period to identify completed contracts. This might be complex where entities sell multiple goods and services, and deliver or render them in different periods, or offer customers options for future goods or services or contracts with no minimum purchase commitment.

Balance of costs and benefits

Entities need to apply selected expedients to all completed contracts. The expedient might be attractive for some contracts but not for others. Management also needs to consider how much the accounting is expected to change. IT systems may need to be re-configured to capture the information to apply both the old and new accounting policies. For example, an entity could have to run parallel systems to capture information for both the accounting under IAS 18/IAS 11 and IFRS 15, if the completed contract expedient is elected.

What's next?

Whether a contract is completed is not always obvious. Do not rush to use the expedient until a thorough assessment has been carried out! Think about the impact of using the expedient on both the preparation of the financial information as well as communications with the stakeholders.

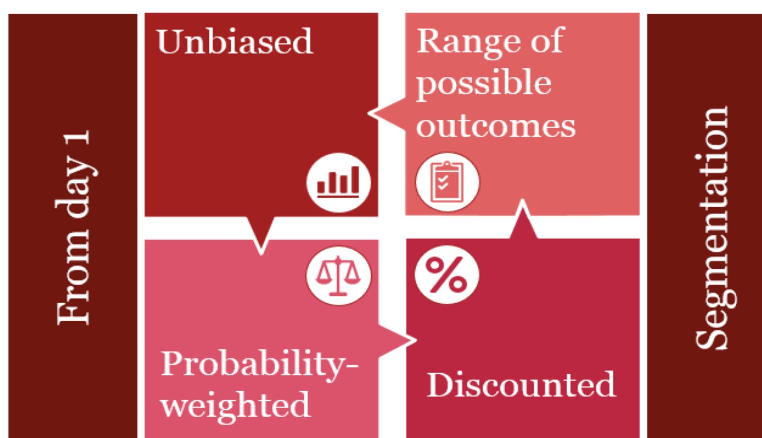
Incorporating forward looking information is a big change under IFRS 9. Irina Sedelnikova, Financial instruments specialist, has fun with expected credit loss models.

Demystifying IFRS 9
IFRS 9 expected credit loss model – simple in practice?

'Time flies when you're having fun', some say. And time certainly has flown when it comes to IFRS 9. We have had the standard for nearly three years with less than a year left until it applies. Banks have spent many hours on its adoption. A key issue is, how can a bank measure expected credit losses (ECL) and comply with IFRS 9 making the best use of the data it already has?

IFRS 9 is clear: entities should recognise ECL throughout the life of a loan, including at initial recognition. A minimum of 12 months ECL is required and if there is a significant increase in credit risk, entities must recognise lifetime ECL

The standard does not prescribe a particular approach to measuring ECL (12 month ECL or lifetime ECL). IFRS 9 lists the following principles: ECL measurement should be unbiased; consider a range of possible outcomes; and should use discounted probability-weighted cash flows. Loan portfolios should be segmented to achieve homogenous groups of loans that share similar credit risk characteristics.



The forward-looking ECL model will be a big change from current practice but an entity doesn't need to start from scratch. Most entities are looking to adjust their existing models to fit IFRS 9 purposes. Commonly used starting points are models used for regulatory capital such as Basel, mapping to external credit ratings and migration analysis based on historical loan loss data.

Basel-based models are probably the most common starting point for banks. The key adjustments likely to be needed to comply with IFRS 9 are set out below. Key inputs to Basel models include probability of default (PD), loss given default (LGD) and exposure at default (EAD). This is not an exhaustive list and other adjustments may be needed.

- PD – through the cycle (Basel) vs point in time (IFRS 9). Basel requires a 12 month PD in conditions neutral to the economic cycle (usually eight to ten years). IFRS 9 requires a PD in current economic conditions including today's forward looking estimates for the life of the loan.

  IFRS 9 PDs will change as an entity moves through the economic cycle while Basel PDs will be less volatile and less sensitive to changes in economic conditions.

- PD – remove prudence: Basel measurement includes prudence, which is contrary to IFRS 9's unbiased principle.
- PD – 12 month vs lifetime: Basel's 12 month PDs will generally need to be converted into lifetime PDs, for assessing significant increases in credit risk and measuring ECL for stage 2 and stage 3 assets.
- PD – forward looking information: Basel PDs should be adjusted to incorporate forward-looking macroeconomic information.
- EAD – prepayments and drawdowns: Basel EAD is based on the contractual term of a loan. The bank should include the expected prepayments for IFRS 9 if a loan allows for prepayments. Banks need to consider expected future drawdowns under revolving credit facilities, such as credit cards.

- LGD – incorporate a number of scenarios: If a bank can recover a defaulted loan in different ways and those have different recovery rates, these different scenarios should be factored into IFRS 9's ECL calculation. This may be different from Basel calculations. Scenarios for recovering a defaulted loan may include foreclosure and sale of collateral, re-negotiation of the contractual terms, or selling the loan. Banks will need to identify the probability of each recovery method and the amount expected to be recovered and weight the results accordingly.

The challenge of ECL measurement under IFRS 9 is obvious. The new standard requires significant judgement, time and effort to adopt – and time is running out. Most banks do not need to start from scratch - they can use much of the information they already have for other purposes - adjusted to ensure compliance with IFRS 9.

Find out more in our short video:

Demystifying IFRS 9 Impairment: 5. Measuring ECL (part 1)

Catch up on the other videos in the series:
Demystifying IFRS 9 Impairment: playlist

The IFRS 15 Mole

PwC revenue specialists investigate the second step of the IFRS 15 model with the help of the Mole

Suspects

Bundled sales.

Incident description

Entities often sell goods and/or services in a bundle, for example a printer and cartridges or a machine with installation services. Step 2 of the IFRS 15 revenue model requires entities to identify performance obligations (POs) at the inception of a contract. Separate POs are then allocated revenue and the revenue is recognised when control of the PO is transferred. A bundle could be one or more POs.

To identify how many POs are in a contract each element of the contract needs to be assessed to see if it is distinct.

A PO is defined as distinct if (a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to customer; and (b) such a promise is separately identifiable from other promises in the contract.

Facts

Case 1 – A contract to provide a printer and a minimum amount of cartridges

A customer requires a printer and a cartridge to be able to print documents. However, the customer could easily buy cartridges from another service provider. The cartridges are likely to be distinct POs even though the customer is required to buy cartridges from the company. A minimum cartridge order is a contractual requirement rather than an indication that the printer and cartridges are not distinct.

Case 2 – A machine which requires specialist installation services

A customer has contracted to buy an installed machine. Practically, installation services can only be provided by the machine seller and therefore the customer cannot benefit from either the machine or installation on its own. This is likely to be one PO in this fact pattern.

If, in contrast, the installation services were customary but could be performed by someone else – for example the purchase and installation of a washing machine, then there would likely be two POs.

Case 3 – Building a wall including provision of bricks and mortar

The contract contains provision of raw materials (bricks and mortar) and a building service. The promise in the contract, however, is to provide a completed wall. Whilst building services could be provided by another builder, the promises are not separately identifiable in the contract (the customer wants a wall not the bricks and mortar) and therefore this would likely be viewed as a single PO.

Recommendations

Contracts for bundled products should be carefully considered to identify if there is more than one PO. The focus should fall on the characteristics of the goods or services rather than the way in which the customer might use them. A customer should be able to benefit from a promise that is distinct on its own and the elements of the bundle should not be so highly interdependent or interrelated that they cannot be separated.

Further investigations

More insights on other aspects of Step 2 of the new revenue standard to come in the next issue. So stay tuned!

Cannon Street Press

Editors choice

IFRS 9 Modification or exchange of financial liabilities

The Board confirmed that when a financial liability measured at amortised cost is modified or exchanged but not derecognised, the entity should re-estimate the contractual cash flows using the original effective interest rate. The entity should recognise any adjustment to the carrying amount of the financial liability estimation in profit or loss at the date of the modification. This is a big change for many entities. Currently many preparers amortised the gain or loss over the remaining term of the financial liability. The Board decided not to release a draft Interpretation to clarify the above. The staff will consider next steps.

Other Highlights

Standard Setting Projects

Insurance

The Board voted on a number of sweep issues relating to the new insurance standard and decided to:

- recognise against the contractual service margin (CSM) all changes in estimates of future cash flows arising from nonfinancial risks under the general model as well as those arising from non-financial risks (and not relating to the underlying items) under the variable fee approach (VFA);
- provide an exemption from the requirement to separately group contracts that fall into different groups because law or regulation constrains an entity's ability to set a different price or level of benefits for policyholders with different characteristics.

The Board expects to issue the standard in May 2017.

Financial Instruments with Characteristics of Equity

The Board tentatively decided:

- to require an entity to apply the Gamma approach to the contractual terms of a financial instrument, consistent with IAS 32 and IFRS 9;
- to consider whether it should take any action to address the accounting for mandatory tender offers, including potential disclosure requirements.
- not to reconsider IFRIC 2 given that it is not aware of any challenges to its application.

These are the editor's top picks from the February Board meeting. For a comprehensive list of all discussions visit the IASB website at www.IFRS.org

A lessee can choose to apply IFRS 16 through either a full retrospective approach or using a simplified approach. Can Professor Lee Singh and his assistant Nitassha Somai help you make the decision that's right for you? Let's experiment!

The leases lab

Hypothesis

Only the simplified approach has operational advantages for a lessee; ergo it is always a better approach for transition.

Testing and analysis

IFRS 16 is mandatory for reporting periods beginning on or after 1 January 2019. Earlier application is permitted but only if IFRS 15 is adopted at the same time.

The standard can be applied either fully retrospectively or through a simplified approach.

Three key practical expedients and transition exemptions are available for lessees:

- Existing contracts do not have to be reassessed to determine if they contain leases. The expedient is applied to all contracts if used.
- Leases with a remaining term of 12 months or less are exempt (a choice on a lease-by-lease basis).
- Low value assets are exempt (a choice on a lease-by-lease basis).

There is no impact on transition for the lessee in a finance lease. The lease liability and carrying amount of the leased asset is carried forward.

Fully retrospective approach

Just like it sounds, the financial statements are presented as if IFRS 16 has always been applied. The impact of adoption is adjusted in the opening balance sheet of the earliest period presented and comparative amounts are restated for each prior period presented.

The implication? A lessee goes back to the point in time it entered into every lease and gathers the necessary information. This is complicated and could have significant cost implications.

Simplified approach

This approach is also applied retrospectively, but the impact of adoption is adjusted against the opening balance of retained earnings on the date of initial application (that is 1 January 2019 for calendar year ends). Comparatives are not restated.

The impact is:

- Lease liability – measured at the present value of remaining lease payments using the incremental borrowing rate on date of initial application.
- Right of use asset – the lessee can choose on a lease by lease basis either to measure the asset at an amount equal to the lease liability **or** as if the standard has always been applied. Again, the incremental borrowing rate on the date of initial application is used.

Practical application

Choosing a transition approach is not straightforward because the simplified approach also has some disadvantages.

Disadvantages:

- Lacks comparability making it more difficult for users to assess performance over time.
- Additional disclosures – a reconciliation must be provided of operating lease commitments previously disclosed under IAS 17 and lease liabilities initially recognised under IFRS 16.
- The incremental borrowing rate must be used on date of initial application to measure the lease liability. This rate is generally lower than the interest rate implicit in the lease. Lease liabilities will be higher on adoption, impacting KPI's and key ratios.

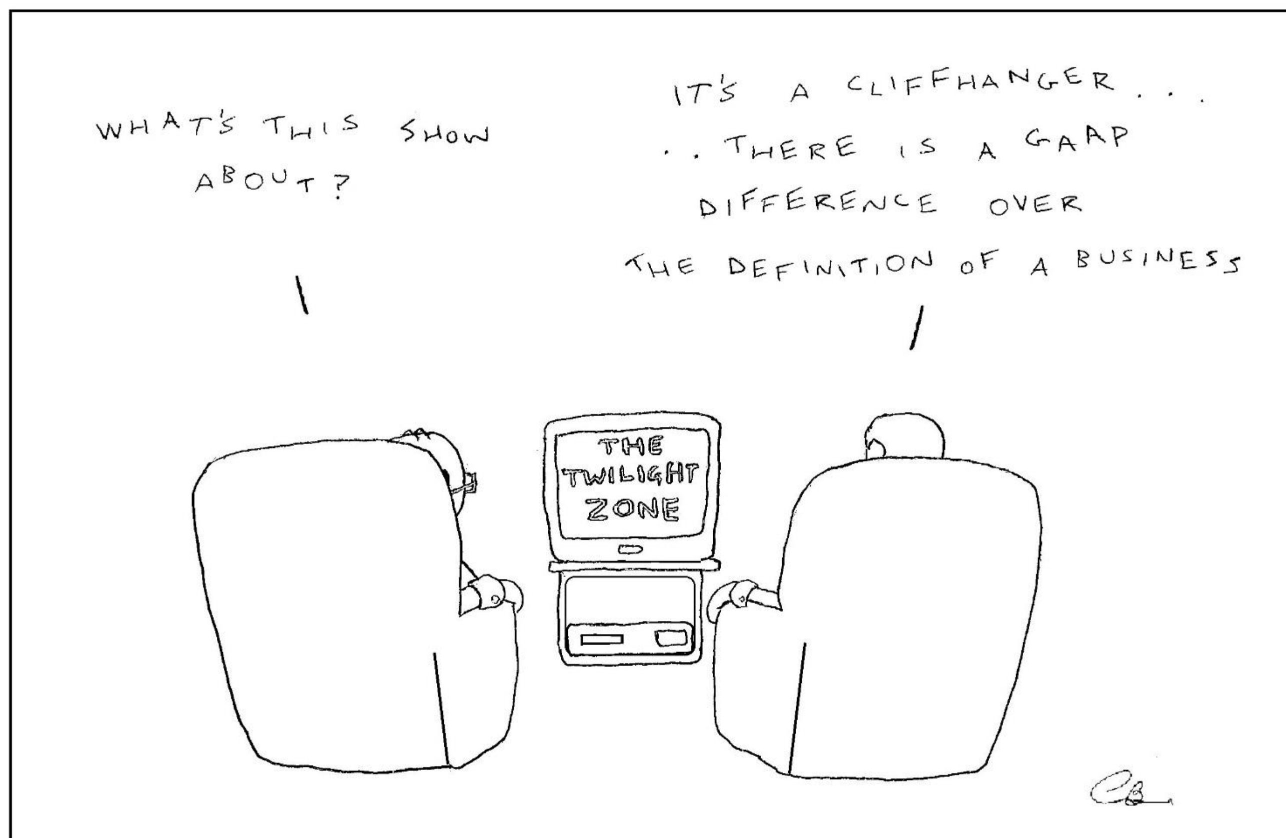
Conclusion

The simplified approach has some operational advantages. There is no need to go back in time to lease commencement dates to measure the right-of-use asset and the lease liability. Information as at the date of initial application is used and comparatives are not restated.

However, the hypothesis that it is always a better choice is incorrect because there are also some disadvantages to the simplified approach. User expectations, impact on KPI's and key ratios and the impact of using the incremental borrowing rate should be considered when deciding which of the two approaches is more suitable.

For more on transition, see our In depth, IFRS 16 – A new era of lease accounting. Our full range of leases content and videos can be found on PwC Inform.

The bit at the back ...



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