Need to know

Disclosing the adoption of new accounting standards in interim financial statements

Contents

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Both IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers* are mandatorily effective for annual periods beginning on or after 1 January 2018. For many companies, the first financial statements reflecting adoption of these significant standards will be an interim report for the six months to June 2018. IFRS 16 *Leases* is also available for early adoption in 2018 financial statements.

The Financial Reporting Council highlighted the importance of proper disclosure in respect of the adoption of IFRS 9 and IFRS 15 in its recent Corporate Reporting Review Briefing, noting that these disclosures should be clear, concise, company-specific and that they should focus on the areas of change. The need to consider the materiality of the impact of new standards in deciding the extent of necessary disclosures was also recognised.

- The detailed disclosure requirements of IFRS 9, IFRS 15 and IFRS 16 do not apply to condensed interim financial statements prepared in accordance with IAS 34 *Interim Financial Statements*. However, that Standard does require disclosure of the effects of changes in accounting policy.
- Judgement will be required in determining the appropriate level of disclosure, including on the level of aggregation which is appropriate, which may differ depending on the extent of the changes resulting from the new standards.
- Certain specific disclosure requirements on revenue have been added to IAS 34 on adoption of IFRS 15, these apply in the year of adoption and in subsequent years.

The disclosure requirements of IAS 34 on changes in accounting policy

Each of IFRS 9 *Financial Instruments* (by means of consequential amendments to IFRS 7 *Financial Instruments: Disclosure*, notably paragraphs 42I-S on the initial application of IFRS 9), IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases* include extensive disclosure requirements both in respect of transition to the requirements of the new Standard and its application on an ongoing basis. However, these requirements do not apply directly to condensed interim financial statements prepared in accordance with IAS 34 *Interim Financial Statements*, which are only required to include disclosures as required by IAS 34 itself.

IAS 34.16A(a) requires "a statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements or, **if those policies or methods have been changed, a description of the nature and effect of the change**." Changes in accounting policy resulting from adoption of new accounting standards are subject to this requirement.

IAS 34.15C also expresses a broader principle that "[w]hen an event or transaction is significant to an understanding of the changes in an entity's financial position or performance since the last annual reporting period, its interim financial report should provide an explanation of and an update to the relevant information included in the financial statements of the last annual reporting period."

Determining the appropriate disclosures necessary to satisfy these requirements as well as investor expectations of information on changes in, for example, reported revenue and profit will necessitate the application of judgement as the appropriate level of disclosure will differ depending on the extent and nature of the changes resulting from each new Standard.

Applying these requirements to changes arising from IFRS 9, IFRS 15 and IFRS 16

In assessing the necessary disclosures in their interim financial statements, entities should consider, inter alia, the need to provide information on the following.

The new accounting policies applied

At a basic level, the disclosures should include a meaningful explanation of the new accounting policies themselves, which will not have been included in the description of accounting policies in the previous annual report (December 2017 for a calendar year-end company). As always, a high quality description of an accounting policy will not simply repeat the requirements of the relevant accounting standard, but will explain how those requirements have been applied to the company's particular facts and circumstances, for example:

- In respect of IFRS 15, how the five-step model for revenue recognition applies to each significant revenue stream, including how contracts are disaggregated into their component performance obligations and whether revenue from each performance obligation should be recognised over time or at a specific point in time (and, if so, at which point in time).

> The FRC's Corporate Reporting Review Briefing specifies that reference to performance obligations is necessary to improve the value of an explanation of the IFRS 15 model.

- In respect of IFRS 9, whether each significant class of the company's financial assets is classified as at amortised cost, fair value through profit or loss or fair value through other comprehensive income and how the expected credit loss model has been applied..

> The FRC's Corporate Reporting Review Briefing reiterates that the key focus for banks will be on impairment, stating that the information provided needs to be sufficient to allow an understanding of the change from an incurred loss model under IAS 39 *Financial Instruments: Recognition and Measurement* to an expected loss approach to a bank's key portfolios of assets.
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> The need for non-financial services companies to provide disclosure of the effect of this change on their accounting for impairment of trade receivables is also noted, particularly for companies with long-term balances (which could include lease commitments, contract assets recognised under IFRS 15 or intercompany receivables). When IFRS 9's 'simplified approach' of measuring the loss allowance for trade receivables and contract assets at the amount of lifetime expected credit losses is applied, companies will need to make clear how that expected amount has been determined.

- In respect of IFRS 16, how the revised definition of a lease applies to the company's significant contracts to use, or take the output from, physical assets.

The transitional method adopted and any practical expedients used

IFRS 15 and IFRS 16 provide a choice between retrospective adoption and adoption from a 'date of initial application' (1 January 2018 for a calendar-year company applying the new Standard for the first time in 2018) with an adjustment to equity reflecting the change in net assets arising at that date. IFRS 9 requires retrospective application but allows for certain decisions on, for example, the designation of financial assets and liabilities to be taken at the date of initial application and in certain cases provides relief from full retrospective measurement of, for example, fair value and expected credit losses.

Each Standard also provides a number of practical expedients that companies may apply either on transition (for example, to 'grandfather' the assessment of whether existing contracts meet the definition of a lease) or on an ongoing basis (for example, on the recognition of short-term leases under IFRS 16 and the identification of significant financing components in revenue contracts under IFRS 15).

When their effect is significant, disclosure of how a company has applied the explicit choices provided by new Standards would normally be appropriate.

The key judgements and estimates applied

Each of the new standards requires the application of careful judgement and the use of estimation. For example:

- IFRS 9's expected credit loss model requires forecasts of future credit losses (rather than, as under IAS 39, only the identification of incurred losses), together with an assessment of credit risk to determine whether expected lifetime or 12-month expected credit losses should be included in the loss allowance.

- IFRS 15 requires significant judgements to be made around, amongst other things, the estimation of variable consideration and the constraint on its recognition, the 'stand-alone selling price' of performance obligations used in allocation of consideration to the components of a contract and whether (and, if so, how) consideration should be recognised as work is performed rather than at a single point in time.

- IFRS 16 requires judgement in identifying whether a right-of-use asset and lease liability should be recognised and, if so, the measurement of those balances. Significantly, this requires determination of the lease term and the identification of a suitable discount rate.

Whilst the requirements of IAS 1 *Presentation of Financial Statements* on key judgements and sources of estimation uncertainty do not apply to condensed interim financial statements, an indication of the judgements taken in applying these complex new requirements can enhance the value of the disclosures provided.

> The FRC highlights in its Corporate Reporting Review Briefing an expectation that significant judgements will be explained and sources of estimation uncertainty quantified; it gives long-term contract accounting and allocation of revenue to multi-element contracts under IFRS 15 and expected credit losses under IFRS 9 as examples of areas where such disclosure may be necessary.

The quantitative effects

In announcing its thematic review of disclosures relating to the implementation of new standards within 2018 interim accounts, the FRC stated that it expects "quantitative disclosure to be accompanied by informative and detailed explanation of the changes".

When previously stated figures are restated or cumulative effect is recognised in equity at the date of initial application of a new standard, those changes should be disclosed and explained.

For annual financial statements, disclosure of the effect of changes in accounting policy on the current year financial statements is required (albeit, the new standards offer some relief from this general requirement of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*). This requirement is not included in IAS 34, but companies should consider whether quantitative or qualitative information on the current year effect on, for example, revenue recognised in the interim period is necessary to provide, as per IAS 34.16A(a), an understanding of "the effect of the change."

Observation
IAS 34.16A(a) does not replicate the specific requirement of IFRS 15.C8 to disclose in annual financial statements "the amount by which each financial statement line item is affected in the current reporting period by the application of [IFRS 15]"or of IAS 8.28(f) to disclose "the amount of the adjustment for each financial statement line item affected." Judgement will be required to determine the appropriate level of disclosure and aggregation necessary to provide users with an understanding of the effects of new standards applied.

In addition, whilst not directly applicable to condensed interim financial statements, the transitional disclosures required in annual financial statements might be referred to in considering whether any more specific quantitative disclosures should be provided. In particular, for financial institutions there may be an expectation from investors that the change in loss allowance on application of IFRS 9 (to be disclosed in annual financial statements per IFRS 7.42P) will be disclosed before the 2018 annual report is published.

Disclosure requirements added to IAS 34 on adoption of IFRS 15

Two specific disclosure requirements have been added to IAS 34 in respect of accounting under IFRS 15, being:

- significant impairment of contract assets; and
- a disaggregation (as required in the annual financial statements) of revenue depicting how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors, together with sufficient information to understand the relationship between that disclosure and revenue disclosed in a segmental analysis.

These disclosures are required both in interim financial statements in the year in which IFRS 15 is adopted and in subsequent years.

IAS 34 also requires that certain disclosures on the fair value of financial instruments from IFRS 13 *Fair Value Measurement* and IFRS 7 *Financial Instruments*: Disclosure be provided in interim financial statements. Whilst these requirements were not added by IFRS 9, they may need to be revised if the population of assets and liabilities measured at fair value changes on application of the new Standard.

Presentation and restatement of comparative information

The requirements for comparative information in condensed interim financial statements are, like those for disclosure, included in IAS 34 itself and are only to provide a statement of financial position at the end of the preceding financial year and a statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the comparable period(s) in the previous financial year. Unlike in annual financial statements, there is no requirement to provide an additional comparative statement of financial position when a change in accounting policy is applied retrospectively.

When comparative information will be changed in the annual financial statements due to retrospective application of IFRS 9 (if not impracticable) or IFRS 15 or IFRS 16 (if that option is chosen), the comparative information provided in condensed interim financial statements should likewise be restated with appropriate, quantitative disclosure and explanation of those changes.

Further information

The effects of IFRS 9, IFRS 15 and IFRS 16 can be many and varied depending on the precise nature of a company's transactions. A suite of resources on each standard is available via www.ukaccountingplus.co.uk.

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