KPMG

Accounting Frontline

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Introducing *"Cutting the clutter"* - helping clients to develop insightful, practical, relevant and structured financial statements

See page 11 for more details

Accounting Advisory Services

KPMG Lower Gulf

Contents

Editorial

In this edition, we focus on some of the challenging and complex IFRS changes that may require detailed analysis by those preparing financial statements.

The Central Bank of the U.A.E. (CBUAE) recently issued a notice to banks and finance houses in the U.A.E., requiring them to assess the impact of implementing IFRS 9 on their financial statements. Impact assessments must be submitted by 16 June 2016. The results are likely to provide useful inputs to the CBUAE when devising policies for IFRS 9 implementation.

Our article on impairment explains the new approach to impairments of financial instruments based on IFRS 9's expected credit loss (ECL) model. The ECL model is conceptually different from the current 'incurred loss' model of loan loss provisioning under IAS 39 and we expect to see a significant impact on loan loss provisions.

The building, construction and real estate (BCRE) sector is an important part of the U.A.E. economy. Our article details some of the key points that BCRE entities should bear in mind with respect to revenue recognition under IFRS 15.

It is crucial companies analyze the effects of mergers and acquisitions while applying the control model within IFRS 10: Consolidated Financial Statements. We explain the three-step model to assess control over an investee entity.

International Public Sector Accounting Standards (IPSAS) are accrual based accounting standards that can be applied by the public sector. We cover some of the important differences between IFRS and IPSAS.

Finally, we have introduced a new 'Cutting the Clutter' solution. Many entities carry legacy notes and disclosures in their financial statements that may no longer be relevant. When cutting the clutter, we work with management to eliminate disclosures that are no longer required and present relevant disclosures in a manner that both meets IFRS requirements and provides useful information to stakeholders.

We would be delighted to receive any feedback or inputs on the topics we have covered.

Yusuf Hassan
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Impact on the construction sector of IFRS 15

IFRS 15 *Revenue from contracts with customers* introduces new revenue recognition principles which clash with certain common construction business practices.

-Yusuf Hassan

Core principle

The core principle of IFRS 15 is that "revenue is recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services". A five step model is provided by the new revenue standard:

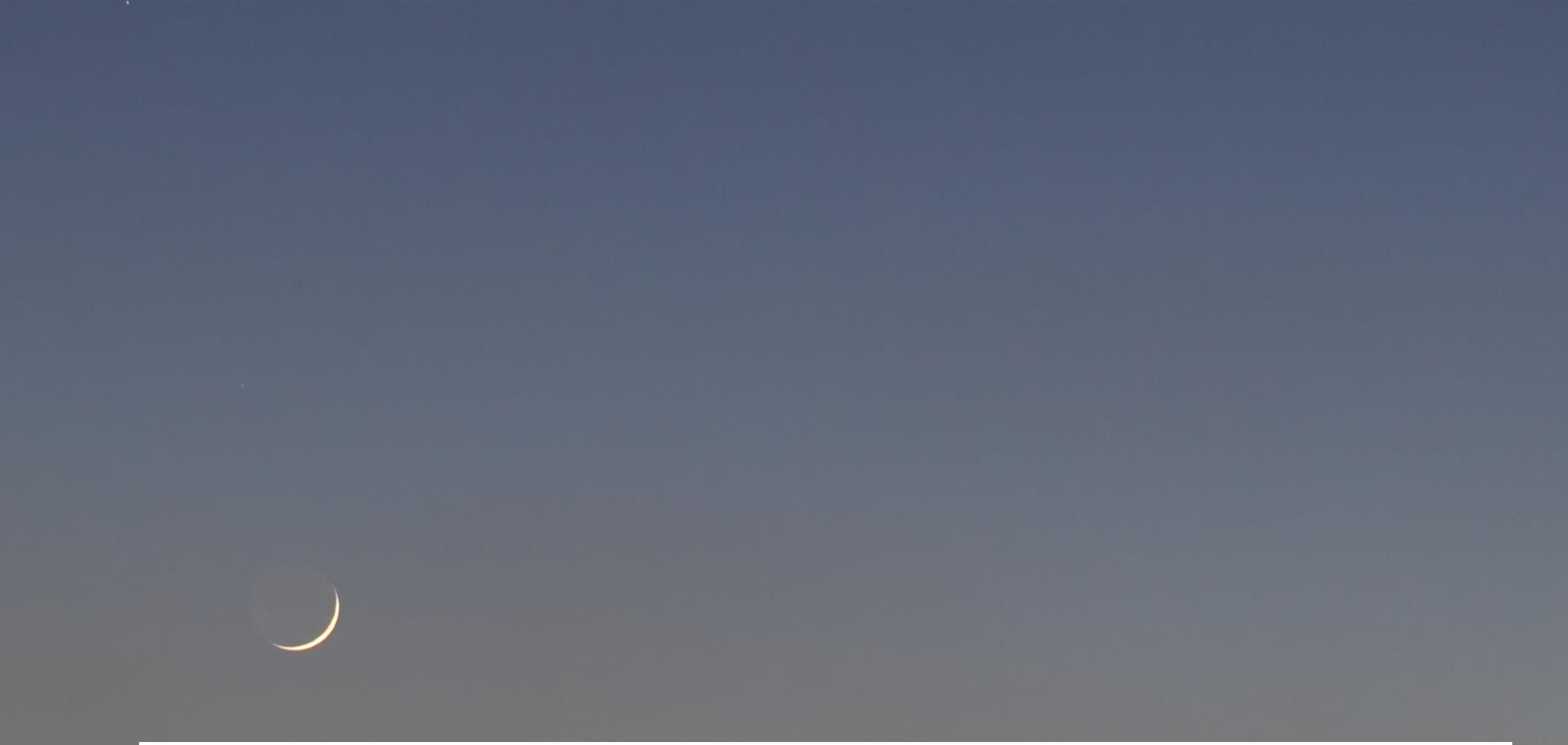
1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract(s).
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue as performance obligations are satisfied.

Pre-contract costs (Capitalization of costs)

Under IAS 11 *Construction contracts* (IAS 11), a broad range of pre-contract costs are allowed to be capitalized when it is probable that a contract will be obtained. Under IFRS 15, the **incremental costs** and **fulfilment costs** of obtaining a contract can only be capitalized when those costs are expected to be recovered. Costs that do not meet these criteria must be expensed as incurred. Under IFRS 15, entities will be able to capitalize less costs, as internal costs are less likely to meet the incremental costs test. An internal bid team staff cost, for example, is unlikely to meet the criteria.

Contract performance obligations

IFRS 15 requires an entity to identify a promise in the contract to transfer a distinct good or service to a customer - also known as a **performance obligation**. A good or service is distinct from other goods and services if the goods or services provide stand-alone benefits to the customer and the goods or services are distinct within the context of the contract.



Under IAS 11, a traditional construction contract relating to an asset (or a combination of assets that are closely inter-related or interdependent) is typically the **unit of account** for a contract.

If the different elements of a construction contract are highly inter-related and integrated, it may be possible to account for the contract as a single performance obligation. If this cannot be demonstrated, the entity may be required to recognize revenue across multiple performance obligations.

Under IFRS 15, the entities will need to document their judgment that the different elements of a construction contract are highly inter-related and that a significant integration service is performed to account for the contract as a single performance obligation.

Revenue 'over time' or 'at a point in time'?

Under IAS 11, revenue and profits in a construction contract should be recognized over time (as a percentage of completion) by referring to the stage of completion of the contract's percentage of completion.

Under IFRS 15, this is not the default accounting treatment. An entity has to meet **specific criteria** to recognize revenue and profit over a period of time. Generally, performance obligations are completed over time, with customers gaining control of assets or benefits as they are created or enhanced. Contractors may be limited – either by contract or practically – on how they transfer assets (or benefits) and have the right to collect costs incurred and a reasonable profit margin.

Variable considerations

Under IAS 11, the revenue on variable considerations like rebates, refunds and incentives is recognized only if it is probable that the revenue will flow to the entity and the amount can be measured reliably. IFRS 15 prescribes specific estimation techniques for variable considerations and only permits variable amounts to be included where it is **highly probable that the revenue will not be reversed**. This may result in later recognition of variable amounts and the deferral of revenue in some cases.

Contract modifications

Under IAS 11, a variation has to be probable for the amount to be included as contract revenue. For instance, a claim must be at an advanced stage of negotiation to be included. Under IFRS 15, contract modifications must be approved to be recognized. Therefore, under IFRS 15, **variations may be recognized later**.

Loss making contracts

Under IAS 11, expected contract losses are immediately recognised as an expense. However, **IFRS 15 does not provide specific guidance** on loss-making contracts. Under IAS 37 *Provisions, contingent liabilities and contingent assets*, a provision should be recognized for loss-making contracts. Loss-making contracts are considered onerous and measured at the best estimate of any unavoidable costs.

Impairment under IFRS 9

How the new 'general model' of impairment provisioning might affect you

In July 2014, the IASB released the final version of IFRS 9 *Financial Instruments* which replaces IAS 39: *Financial Instruments: Recognition and Measurement*. The new standard is effective for periods beginning of or after 1 January, 2018, with early adopted permitted (subject to local requirements).

Not all financial assets are within the scope of IFRS 9's impairment requirements:

In scope

- Debt instruments measured at amortized cost or at FVOCI
- Issued loan commitments not measured at FVTPL
- Issued financial guarantee contracts not measured at FVTPL
- Lease receivables covered by IAS 17
- Contract assets covered by IFRS 15

Out of scope

- Equity investments
- Issued loan commitments measured at FVTPL
- Other financial instruments measured at FVTPL

IFRS 9 amends the impairment model, commonly referred to as the 'general model'. This model requires impairment provisioning to be based on expected, rather than incurred, losses (as was required by IAS 39), making design and implementation highly complex.

The general model also requires account balances to be segregated into three different stages based on their risk profile. Provisioning is different for each stage:

	Stage 1	Stage 2	Stage 3
Financial asset	Performing	Significant increase in credit risk	Credit-impaired or non-performing
Loss allowance	12 month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Interest	On gross carrying amount	On gross carrying amount	On net carrying amount

IFRS 9 requires that an impairment loss amounting to 12 months of expected credit losses - resulting from default events expected to occur within 12 months of the reporting date - be recognized immediately upon the recognition of such assets.

To determine whether there has been a significant increase in credit risk, use the credit risk at recognition and not at the previous reporting date. 'Significant increase in credit risk' is not defined in IFRS 9, and is unique to each entity, so a considerable amount of judgment is required. If this is determined to be too sensitive, or not sensitive enough, your profit or loss movements may be volatile.

IFRS 9 has a rebuttable presumption that a significant increase in credit risk has occurred once balances are outstanding by more than 30 days. Delinquency, however, is a lagging indicator and significant increases in credit risk may occur before an asset becomes past due. Therefore, if more forward-looking information becomes available, it should be used together with the historical past-due data.

Stage 1: Performing financial assets

These are financially healthy assets performing as expected, in line with their contractual terms, with no sign of increasing credit risk. IFRS 9 requires that an impairment loss amounting to 12 months of expected credit losses - resulting from default events expected to occur within 12 months of the reporting date - be recognized immediately upon the recognition of such assets.

Interest income is calculated on the gross carrying amount, based on the effective interest rate method, and so the loss allowance is not taken into account at this point.

Stage 2: Financial assets with a significantly increased credit risk

When the credit risk of a financial asset at the reporting date has increased significantly, a loss allowance equal to the expected credit losses over the lifetime of the asset must be recognized.

Lifetime expected credit losses are the present value of all credit losses that arise if a borrower defaults on their obligations throughout the lifetime of the financial instrument. Therefore, when referring to 12 month expected credit losses (in stage 1), it relates to a 12 month portion of the lifetime expected credit loss.

When analyzing expected credit losses, the present value of expected cash flows needs to be compared against the present value of contractual cash flows. Any difference in timing may impact the present value and thus affect impairment.

Interest revenue in stage 2 is still calculated on a gross basis.

Stage 3: Credit-impaired or non-performing financial assets

Financial assets that have become credit impaired, meaning that a default event has already occurred, are stage 3 assets and lifetime expected credit losses must be recognized. Individual balances may need to be analyzed, rather than portfolios.

Interest revenue is calculated and recognized on a net basis, meaning that the loss allowance is taken into account.

Loan commitments and financial guarantees

Financial assets that are recognized as a result of a draw-down of loan commitments (such as revolving credit facilities) are considered to be a continuation of the initial loan commitment for impairment purposes. Therefore, when assessing whether or not there has been a significant increase in credit risk, the date of initial recognition is considered to be the date at which the entity becomes a party to the irrevocable commitment.

Credit risk will be low if:

- **There is a low risk of default**
- **The borrower is able to meet its contractual cash flow obligations in the near term**
- **Adverse changes in economic and business conditions in the longer term may, but not necessarily will, reduce the borrower's ability to fulfil its obligations.**

Another critical decision that management will need to make, and where they will need to exercise a considerable amount of judgment, relates to 'default' as it is not defined in IFRS 9. The definition used by management will need to be consistent with that used for internal credit risk management purposes and has to take qualitative factors such as breaches of covenants into account.

IFRS 9 contains a rebuttable presumption that default occurs once balances become 90 days past due, unless there is reasonable and supportable information to corroborate a more lagging default definition.

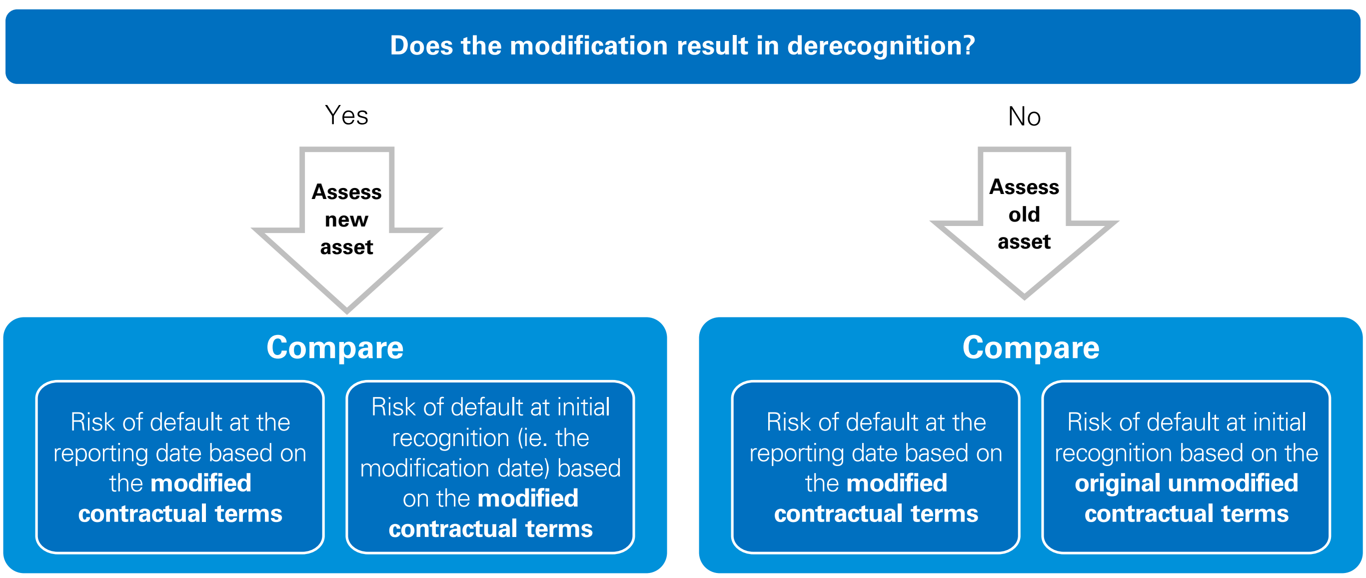
Assets with low credit risk

At the reporting date, assets with low credit risk will be stage one as they do not meet the criteria for recognizing lifetime expected credit losses. The assessment of whether an instrument has a low credit risk will need to be done on an instrument-by-instrument basis.

Generally, financial instruments with an external rating of 'investment grade' are considered to be low credit risk. However, a financial instrument does not have to have an external rating in order to be considered low credit risk. If internal ratings are used, the internal assessment should take into account all terms and conditions of the financial instrument and should equate to a globally understood definition of low credit risk. Any assessment should be consistent with market participants.

Modified financial assets

If the contractual cash flows of a financial assets are modified, entities will need to distinguish between modifications that do and don't result in derecognition:



Assets that are credit-impaired at initial recognition

There are special requirements for assets which are credit impaired at the time of purchase or origination. An asset is credit-impaired if one or more events, or a combination of events, have occurred that have a detrimental impact on estimated future cash flows.

At initial recognition, the lifetime expected credit losses should be incorporated into the calculation of the Effective Interest Rate (EIR), instead of having an impairment allowance. Subsequently, lifetime expected credit losses are measured and the amount recognized as any loss allowance reflects the movement in lifetime expected credit loss since initial recognition. Favorable changes are recognized as an impairment gain.

Examples include:

- **The issuer or borrower is in significant financial difficulty**
- **A breach of contract, for example, a default or past-due event**
- **A borrower is granted a concession due to financial difficulty**
- **The likelihood that the borrower will enter bankruptcy or other financial reorganization**
- **The active market for the financial asset disappears**
- **A financial asset is brought at a deep discount, reflecting incurred credit losses**

What makes this model so demanding?

This model requires reliable information which may be difficult to get. Information to determine credit risk and whether or not there has been a significant increase in the credit risk will need to be obtained from a reliable source and needs to be verifiable.

Other challenges includes finding information to estimate the occurrence of default events within 12 months of the reporting date and information to estimate the occurrence of default events within the lifetime of the instrument, their probable outcomes and their weighting. A slight change in just one parameter could affect the amount of recognized impairment loss.

As a result, more complex information systems may need to be designed and implemented to process all of the required information and to monitor whether or not the information has changed (such as market indicators including oil and gold prices).

Evaluating control under IFRS 10

IFRS 10 *Consolidated Financial Statement* was issued in May 2011 and applies to annual periods beginning on or after 1 January 2013. However, some IFRS 10 provisions need the judgment and, if not done appropriately, could lead to misstatements in consolidated financial statements.

Power + **Exposure to variable returns** + **Link between power and returns** = **Control**

An investor must consolidate an investee from the date on which it obtains control.

IFRS 10 introduced a single control model which replaced the previous guidance in IAS 27 *Consolidated and separate financial statements* and SIC-12 *Consolidation – special purpose entities.* According to IFRS 10, investors have control when they control **all three cumulative elements** (power, exposure to variability of returns and linkage between power and returns).

Step 1: Does the investor have power over the investee's relevant activities?

To have power over an investee, the entity must have rights that enable it to direct any activities that significantly affect the investee's returns (also called the investee's relevant activities).

The investor must identify the investee, understand its business model and its corporate governance, and identify all relevant activities. This is likely to involve the exercise of judgment.

The key issue is to discuss whether rights are substantive or protective. Substantive rights – such as the employment of key managerial personnel, the acquisition and disposal of capital assets and the approval of annual business plans - have to be exercisable when decisions about relevant activities are being made.

Identify the investee - Control is generally assessed at the legal entity level.

Understand the investee's purpose and design - This may require a detailed knowledge of the business.

Identify the investee's relevant activities - Does the activity significantly affect returns?

Step 2: Is the investor exposed to the investee's variable returns?

An investor is exposed to variable returns if the returns from its involvement with the investee vary based on the investee's performance – that is, returns are not limited to benefits. Returns can be negative, positive or both. There are many types of returns, such as, dividends on equity securities, interest on debt securities, management fees and changes in value. In practice, the variability assessment usually depends on whether the investor holds debt or equity in the investee. IFRS 10 is clear that involvement through debt or equity instruments exposes an investor to variable returns. However, an in-depth variability analysis might be required if the involvement is neither debt nor equity. The investor should return to the initial variable return definition.

Step A – Analyze investee risks

Step B – Analyze how any of those risks are passed to other parties

Step C – Assess the investor's exposure to those risks

Step 3: Is there a link between the power of the investor and its returns?

To have control, in addition to power and exposure to variable returns, an investor must be able to use its power over the investee to affect returns. In applying the linkage test, the investor must consider relationships with other parties. In practice, the investors should determine whether it is using rights for its own benefits (and so acting as a principal) or for the benefits of others (an agent). If the investor is an agent, IFRS 10 is clear that the linkage element is missing and so the investor does not control the investee.

Mind the gap: Differences between IPSAS vs IFRS

The state of government reporting is the elephant in the room.
Vincenzo LaVia
World Bank Group CFO

Key differences between International Public Sector Accounting Standards (IPSAS) and International Financial Reporting Standards (IFRS)

Recent financial and sovereign debt crises have highlighted, as never before, the need for better financial reporting by governments worldwide, and the need for improvement in the management of public sector resources.

To improve accountability and transparency in government reporting, the IPSAS board has developed IPSAS which are fundamentally based on IFRS. However, IFRS are more focused on profit-oriented entities, whereas IPSAS have been developed for government entities which focus on service delivery as well as budget management.

Reflecting the differences between the public and private sectors, the IPSAS board made a number of changes when developing IPSAS, including:

Presentation of financial statements

IPSAS compares actual and budgeted financial performance, allowing users to evaluate how a government entity uses and manages its budget.

Non-exchange transactions and government grants

Non-exchange transactions, which are unusual in the private sector, are customary in the public sector. As a result, IPSAS addresses issues arising from recognizing and measuring revenue from non-exchange transactions – that is, an entity that receives, or gives, a disproportionate value.

Accounting for heritage assets

Some assets are described as heritage assets because of their cultural, environmental, or historical significance, such as historical buildings, monuments and archaeological sites. IPSAS allows (that is, it is not required but is not prohibited either) the recognition of heritage assets. If an entity recognizes heritage assets, it is required to comply with IPSAS disclosure requirements and can, but does not have to, comply with other IPSAS requirements regarding those heritage assets.

Impairment of non-cash generating assets

Under IFRS, impairment is determined by the recoverable value of the asset based on its value in use or its fair value less the cost of disposal. However, since assets are often held in the public sector with no objective of generating a return, impairment under IPSAS is determined based on the decline in utility of the asset to the entity that controls it.

Consolidated and separate financial statements

One main difference between IPSAS and IFRS is how control of an entity is determined for consolidation. IPSAS is based on IAS 27 *Consolidated and Separate Financial Statements* while IFRS has issued IFRS 10: *Consolidated financial statements* which amends guidance on assessing control. However, the IPSAS board has now published new standards with an effective date of on or after 1 January 2017 which addresses these differences.

Classification and measurement of financial assets

At present, the IPSAS board has not updated IPSAS to reflect the new requirements under IFRS 9 *Financial instruments* which is applicable to the private sector from 1 January 2018. As a result, the classification and measurement of financial instruments will differ.

"Cutting the clutter"

Common mistakes made by those who are responsible for preparing financial statements, include:

— Excessive disclosures

— Repetition

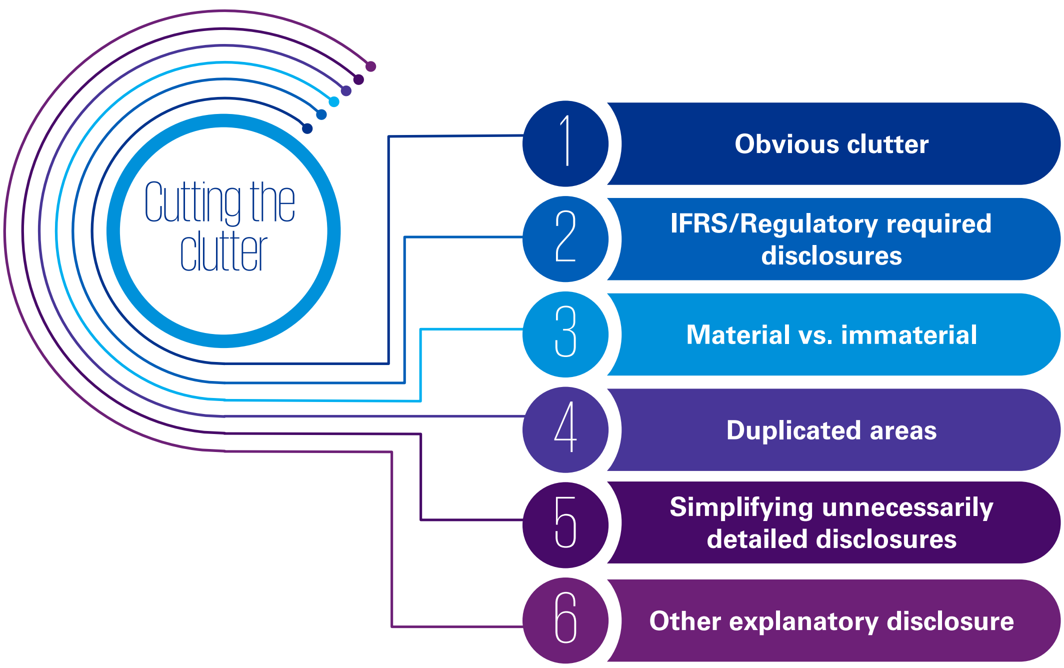
— Immaterial or irrelevant information

— Complicated wording

— Inefficient formatting

Some – or all – of these mistakes can overload financial statements, making things look much more complex than they really are, and make it difficult for stakeholders to focus on the most critical and important areas. Our new Accounting Advisory Services (AAS) solution – which cuts the clutter out of financial statements – helps clients identify how financial statements could be improved and disclosures made more relevant. Wide experience has helped our market-leading AAS team develop a six step system which helps focus financial information, leading to a quality-focused presentation.

Program approach - 6 step methodology



Our solution helps clients develop insightful, practical, relevant and structured financial statements which:

— Disclose relevant, important information without overloading the reader

— Highlight significant accounting policy choices and their implications

— Draft specific disclosures

— Are user-friendly, improving user perception

— Cut time

— Simpify preparation

Recently we successfully trialed our solution with one of the world's largest port operator. The consolidated financial statements were reduced from 112 to 63 pages, improving both structure and presentation. We helped our client remove unnecessary disclosures and insignificant information and formatted tabular data more logically, transforming their consolidated financial statements into a transparent, logical and value adding document.

KPMG Business Academy

Creating value through knowledge

KPMG Business Academy provides learning and development solutions to professionals across the region.

KPMG Business Academy advantages:

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- Our faculty of professionals share global expertise from across the network
- Our robust training approach combines knowledge and practical skills
- Delivered at convenient times and venue

We support the educational objectives of our clients from the identification of goals to detailed elaboration and implementation.

We bring leading practice as a member of the global network of educational practice KPMG provides.

From early career support to boardroom progression, we develop professionals, empower career development and strengthen skills and capabilities.

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