NOVEMBER 2019
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ACCOUNTING NEWS

BDO INTERACTIVE ELEARNING MATERIALS ON ACCOUNTING FOR INCOME AND REVENUE BY NFPs

Australian not-for-profit entities (NFPs) are experiencing the biggest upheaval in financial reporting since Australia adopted International Financial Reporting Standards (IFRS) in 2005.

Having already applied the new financial instruments standard (AASB 9) at December 2018/June 2019, this next reporting season will see the introduction of three new standards (the 'triple-threat accounting standards') for NFPs on leases (AASB 16), revenue from contracts with customers (AASB 15) and income (AASB 1058).

BDO is proud to launch our new interactive NFP elearning module on accounting for income and revenue by NFPs. This free, interactive elearning module on AASB 1058 and Appendix F of AASB 15 includes guidance and examples to demonstrate how the principles of these standards apply in practice.

WHERE TO ACCESS?

You can access all of our elearning modules on our website.

MORE INFORMATION

For more information please contact your BDO adviser.

IN THIS EDITION

In our not-for-profit section of this newsletter, we are proud to launch our new interactive elearning module on accounting for income and revenue by NFPs, and showcase the AASB's latest FAQ to assist research entities in determining whether there are sufficiently specific performance obligations under AASB 15 for a research grant.

In other regulatory activity, we provide a practical step-based approach to implementing the new IFRIC 23 dealing with uncertain tax positions, which applies for the first time to entities reporting full year results at 31 December 2019.

Lastly, we continue to explore further aspects of the 'triple threat' accounting standards. We delve deeper into some of the impacts that IFRS 16 is likely to have on your business, look at how to assess if a contract is a 'lease' under IFRS 16 (specifically if there is an identified asset), and also illustrate how the new financial instrument standard, IFRS 9, will impact the calculation of expected credit losses on financial assets acquired as part of a business combination.

AASB ISSUES NEW FAQ TO ASSIST IN DETERMINING WHETHER THERE ARE SUFFICIENTLY SPECIFIC PERFORMANCE OBLIGATIONS UNDER AASB 15 FOR A RESEARCH GRANT

The Australian Accounting Standards Board (AASB) previously issued FAQ 5 to assist research entities receiving grant funding in determining the appropriate Accounting Standard to apply when recognising revenue or income under AASB 15 *Revenue from Contracts with Customers* or AASB 1058 *Income of Not-for-Profit Entities* respectively. FAQ 5 is limited to the following 'sufficiently specific' performance obligations being provided to a customer:

- Intellectual property
- Licence to use the NFP's intellectual property, and
- Research findings.

In particular, Chart 3 to FAQ 5 illustrates how research findings transferred to a customer that are considered 'sufficiently specific' are recognised under AASB 15 by referring to Examples 4A, 4B and 4C in Appendix F to AASB 15. However, those examples simply refer to 'publication of research data on a public web site' as resulting in a 'sufficiently specific' performance obligation. There is not much guidance provided on factors to consider when assessing whether the requirement to undertake research activities would result in 'sufficiently specific' performance obligations or not.

In October 2019, the AASB therefore updated these FAQs and added FAQ 6 to provide NFPs receiving research grants with some guidance on the types of activities that are not considered 'sufficiently specific' performance obligations, and those that could be. The principles in FAQ 6 are summarised below.

INPUTS AND PROCESSES ARE NOT 'SUFFICIENTLY SPECIFIC'

Grant agreements to conduct research activities are typically not specific as to the detailed outputs required from research activities because research, by its nature, is inherently uncertain. Instead, these agreements tend to be specific in terms of the objectives of the research and how the research will be conducted (i.e. specificity about inputs and processes).

OUTPUTS

In our October 2019 Accounting News article, we outlined a practical approach for analysing grant contracts to determine if they contain 'sufficiently specific' performance obligations where there is an enforceable contract with a customer. We noted there that 'inputs' and 'outcomes/objectives' do not result in the presence of 'sufficiently specific' performance obligations, however, 'outputs' typically would because they are the deliverables described in the grant contract that result in the transfer of a good or service to the customer.

FAQ 6 notes that in order for a performance obligation to be 'sufficiently specific' under AASB 15:

- The research entity must promise to transfer goods or services (e.g. **outputs from the research**) to the customer (i.e. the donor or to other parties on behalf of the donor), and
- That promise must be sufficiently specific such that it can be determined when the research entity has satisfied its obligation to transfer those goods or services.

Both of the above factors must be present in order for the research entity to conclude that there are 'sufficiently specific' performance obligations in the grant contract.

EXAMPLES

FAQ 6 then provides some examples of rights of the donor, and for each, notes whether these would be considered 'sufficiently specific' performance obligations. These examples are summarised in the table below. Please refer to FAQ 6 for more detailed information.

NATURE OF DONOR'S RIGHT	SUFFICIENTLY SPECIFIC PERFORMANCE OBLIGATION?
Financial reports & acquittal statements (how the research entity spent the grant funds)	No. The requirement to submit financial reports and acquittal statements to the donor is specific as to the type (e.g. format and content) and frequency. However, these do not represent a good or service that is transferred to the donor. These reports/statements simply provide evidence to the donor that the research entity has discharged its accountability for the grant funding received, i.e. spent grant monies in accordance with the agreement. *BDO comment:* *Preparation of financial reports and acquittal statements usually only represent an 'input' to the research process, and is not an 'output' of the research to the donor.*

NATURE OF DONOR'S RIGHT	SUFFICIENTLY SPECIFIC PERFORMANCE OBLIGATION?
Progress reports	Typically no. The content of progress reports do not normally transfer a good or service to the donor because they do not communicate information about the findings or the research data from the research performed to date. These progress reports simply provide evidence to the donor that the research entity has discharged its accountability for the grant funding received, i.e. spent grant monies in accordance with the agreement. *BDO comment:* *Preparation of progress reports usually only represent an 'input' to the research process, and is not an 'output' of the research to the donor.*
Final report	Typically no. Same as for progress reports above. However, if the final report provides research findings in some form then it could be considered a 'sufficiently specific' performance obligation.
Report on the research activity requested by the donor	Typically no. Such reports do not normally provide research findings. They typically only provide evidence to the donor that the research entity has discharged its accountability for the grant funding received, i.e. spent grant monies in accordance with the agreement. They do not usually communicate information on the research findings in sufficient detail for the recipient to be able to obtain any substantive benefit from that information. *BDO comment:* *Preparation of a report on the research activity usually only represents an 'input' to the research process, and is not an 'output' of the research to the donor.*
Access to personnel and premises	No. The purpose of the donor having this right is for them to manage risks associated with the research project, rather than to provide access that would enable the donor to obtain a benefit from the research itself.
Access to information and 'research material' – includes the project proposal and summary, progress reports and final reports only	No. Such research material typically only provides evidence to the donor that the research entity has discharged its accountability for the grant funding received, i.e. spent grant monies in accordance with the agreement. It does result in the transfer of a good or service to the donor.
Access to information and 'research material' – includes the project proposal and summary, progress reports and final reports, plus research data, findings or publications created from that data	Yes. Research data, detailed findings or publications created from the data would result in the transfer of a good or service to the donor (customer).
Licence to IP relating to 'research material' - includes the project proposal and summary, progress reports and final reports only	Typically no. The licence is to the research material, which is defined as the project proposal and summary, progress reports and final reports, and the nature of the research materials (as defined by the agreement) does not include the underlying research data, findings or publications created from that data. The focus of the licence is to provide evidence to the donor that the research entity has discharged its accountability for the grant funding received, i.e. spent grant monies in accordance with the agreement. It does not result in the transfer of goods or services to the donor.
Licence to IP relating to 'research material' - includes the project proposal and summary, progress reports and final reports, plus research data, findings or publications created from that data	Yes. Research data, detailed findings or publications created from the data would result in the transfer of a good or service to the donor (customer).

NATURE OF DONOR'S RIGHT	SUFFICIENTLY SPECIFIC PERFORMANCE OBLIGATION?
Intellectual property created from the research	Yes. *For more information:* ▶ Refer Chart 1 in research grant flowchart (AASB FAQ 5) ▶ See Accounting News article, April 2019
Licence to the IP created from the research	Yes. *For more information:* ▶ Refer Chart 2 in research grant flowchart (AASB FAQ 5) ▶ See Accounting News article, May 2019
Research findings (including publications)	Yes. *For more information:* ▶ Refer Chart 3 in research grant flowchart (AASB FAQ 5) ▶ See Accounting News article, June 2019.

NEXT MONTH

In next month's Accounting News, we continue our focus on how research entities determine whether grant agreements contain sufficiently specific performance obligations by looking at some practical scenarios included in FAQ 6.

IFRIC 23 – A PRACTICAL APPROACH TO IMPLEMENTATION

With the first period upon us where IFRIC 23 *Uncertainty over Income Tax Treatments* applies (i.e. annual periods commencing on or after 1 January 2019), boards and management should be turning their focus towards the practical steps required to address the implementation of the new requirements.

In this regard, BDO has developed the following step plan based on engagements with early adopters of the interpretation:

1. **Internal communication and education** – This is a necessary step to obtaining stakeholder buy-in and freeing up the necessary resources for what can be a complex process.
2. **Formulation of an implementation plan** – Depending on the volume of uncertain tax positions that a group has, preparation of a detailed implementation plan can provide structure to the process assisting in timely completion prior to the completion of the audit.
3. **Identification of all uncertain tax positions** – This critical step is fundamental to the success of the overall project, with all potentially uncertain tax positions requiring identification for further analysis.
4. **Assess and develop supporting documentation** – Preparation of this documentation is critical when the audit process commences because the auditors are required to address whether 'sufficient appropriate audit evidence' has been provided to allow them to conclude on the accuracy of the financial statements.
5. **Prepare draft financial statement presentation and disclosures** – The level of disclosures will vary depending on the type of financial statements required, however the general guide is that an increased level of disclosure (quantitative and qualitative) is likely to be required.
6. **Change or develop internal controls** – To ensure that uncertain tax positions are identified and appropriately documented on a real-time basis going forwards, as this will create an easier audit process in future with no risk of omissions.
7. **Revisit tax planning** – This step may be a natural follow-on from the identification process, where the group may ask whether they wish to 'unwind' existing uncertain tax positions, particularly given their disclosure under IFRIC 23.
8. **Determine an appropriate process for ongoing compliance** – If not fully addressed by the changes in internal controls, this may involve expanding existing role descriptions to ensure that uncertain tax positions are appropriately considered and evaluated by senior personnel.

With audit planning meetings having commenced already for a number of groups with 31 December year-ends, this practical step-based approach should be implemented as a matter of haste, particularly where insufficient time has been devoted to addressing the requirements of IFRIC 23 to date.

HOW CAN BDO ASSIST?

Our experts at BDO have in-depth experience in the introduction and application of similar accounting requirements and recommend that you consider engaging an advisor who can both provide you with a clear road map to meet your obligations under the Interpretation and best represent your interests in an audit scenario.

Please contact a member of the relevant BDO team if you require assistance:

IFRS Advisory
Transfer Pricing
Corporate and International Tax
R&D

MORE INFORMATION

For more information on IFRIC 23, please refer to our previous Accounting News articles in August 2019, June 2019 and July 2017.

IFRS 16 ON TRACK FOR A NEW LEASE ON LIFE

In a recent article published by Chartered Accountants Australia and New Zealand (CAANZ), Aletta Boshoff, BDO's National Leader, IFRS Advisory, delves deeper into the impacts that the new leases standard, IFRS 16 *Leases*, will have on businesses.

Besides the immediate impacts on the financial statements of lessees from capitalising almost all leases on the balance sheet (e.g. poorer debt ratios but improved EBITDA and operating cash flows), there are many broader business implications for boards and management to consider, such as the ability to declare dividends, impact on bank covenants, changes to systems and processes to deal with the new requirements, and which transition method to use, as well as any potential tax implications.

Please read the CAANZ article for more information.

WHEN IS A LEASE NOT A LEASE – IS THERE AN IDENTIFIED ASSET?

In the April 2018 edition of *Accounting News* we noted that IFRS 16 *Leases*, which comes into effect for financial reporting periods beginning on or after 1 January 2019, will fundamentally change the manner in which **lessees account for leases**, by requiring lessees to recognise lease liabilities and associated right-of-use assets for the leases that they enter into (with some very limited exemptions).

This means that IFRS 16 only applies to 'leases', and the big questions then are:

- When does an ordinary contract contain a 'lease', and
- When is a lease not a 'lease'?

Except for entities with 'finance leases' under IAS 17 *Leases*, in the past, there was little necessity for entities to analyse in detail whether they had a 'lease' (i.e. operating lease). This is because rental and similar types of arrangements would, in many cases, result in an accounting treatment not dissimilar to expensing operating leases under IAS 17 where the impact of straight-lining an operating lease was not material.

However, under IFRS 16, with the requirement for lessees to capitalise most leases on the balance sheet, identifying what is, and what is not, a 'lease' is of utmost importance.

WHAT IS A 'LEASE'?

A 'lease' is defined in IFRS 16 as follows:

A contract, or part of a contract, that **conveys the right to use an asset (the underlying asset)** for a period of time in exchange for consideration.

Definition of a 'lease' in IFRS 16

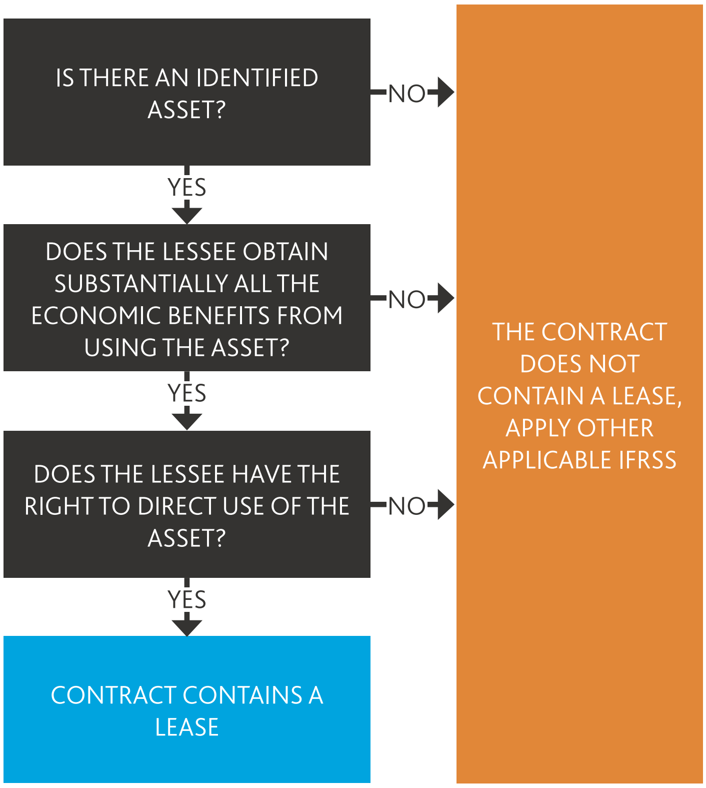
IFRS 16, paragraph 9 then says that a contract is, or contains, a 'lease' if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. This means that there are two key matters that require consideration in assessing whether a contract is, or contains, a 'lease':

- Whether there is an identified asset, and
- Whether the contract conveys the right to control the use of the identified asset.

In regards to the second key matter identified above, IFRS 16, paragraph B9 notes that in order for a contract to convey the right to control the use of the identified asset, the customer must have **both** of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset, and
- The right to direct the use of the identified asset.

This is illustrated in the diagram below.



The above requirements are discussed in more detail in our July 2018 Accounting News article.

In this article, we will focus on the first consideration, i.e. what we mean by 'an identified asset', and look at some examples of where there is, and is not, an identified asset. In future editions, we will explore in further detail whether the contract conveys the right to control the use of an identified asset.

IS THERE AN IDENTIFIED ASSET?

An asset is typically identified by being **explicitly specified** in a contract, for example by specifying the registration number of a car, as well as the manufacturer and model type. However, an asset can also be identified by being **implicitly** specified at the time that it is made available for use by the customer.

PORTIONS OF ASSETS

A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). However, a capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from using the asset.

Example 1 – Fibre optic cable

A customer enters into a 15-year contract with a supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong and Tokyo.

The specified amount is equivalent to the customer having the full capacity of three fibre strands within a 15-strand cable.

The supplier makes decisions about the transmission of data (i.e. which fibres are used to transmit the lessee's data).

Assessment

The contract **does not contain a lease** because the capacity specified is not physically distinct and it does not represent substantially all of the underlying asset (i.e. the capacity is only 20% of the total capacity of the cable).

If the contract specified an amount of capacity equivalent to say 14 fibre strands of the total cable, the contract would contain a lease because this represents substantially all (approximately 94%) of the cable's capacity.

Example 2 – Fibre Optic Cable (specific strands)

A customer enters into a 15-year contract with a supplier for the right to use three of 10 specific strands of fibre optic cable connecting Paris and London.

The customer has the exclusive right to use these strands to transfer their data.

Assessment

The contract **does contain an identified asset** because the strands of fibre optic cable are distinct from one another and the vendor does not have the right to substitute the strands for others in the same cable.

Despite the number of strands not being substantially all of the cable's total capacity, the strands are identified (physically distinct), therefore the contract provides a specified asset to the customer.

BDO comment:

The requirement that a portion of an asset can meet the identifiability criterion can be seen as a potential 'anti-avoidance' provision of the standard. Without this provision, a contract could exclude an insignificant portion of an asset's capability, and not meet the identifiability criterion.

Although IFRS 16 makes reference to a capacity portion that is 'physically distinct', in our view this approach also applies when a capacity portion is technologically distinct. For example, a lease could be of all of the light blue colour capacity of a fibre optic cable. In that case, the light blue component would be an identified asset for the purposes of IFRS 16.

Example 3 – Sub-surface rights (extracted from IFRIC agenda decision – June 2019)

A pipeline operator (customer) obtains the right to place an oil pipeline in underground space for 20 years in exchange for consideration.

The contract specifies the exact location and dimensions (path, width and depth) of the underground space within which the pipeline will be placed.

The landowner retains the right to use the surface of the land above the pipeline, but it has no right to access or otherwise change the use of the specified underground space throughout the 20-year period of use.

The customer has the right to perform inspection, repairs and maintenance work (including replacing damaged sections of the pipeline when necessary).

IFRIC agenda decision

As this contract did not meet one of the scope exceptions in IFRS 16, the pipeline operator would need to consider whether the contract contains a lease as defined in IFRS 16.

The Committee observed that IFRS 16.B20 states that a 'capacity portion of an asset is an identified asset if it is physically distinct', subject to the lessor not having substantive substitution rights.

In the fact pattern described, the specified underground space is physically distinct because the contract specifies the path, width and depth of the pipeline.

The fact that the space is underground and therefore does not include the surface area of the land is not relevant. This space is physically distinct in the same way that a portion of land on the surface may be physically distinct. Therefore, as no substitution rights exist, the Committee concluded that an **identified asset does exist.**

SUBSTITUTION RIGHTS

Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use.

A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

- The supplier has the practical ability to substitute alternative assets throughout the period of use, and
- The supplier would benefit economically from the exercise of its right to substitute the asset.

BDO comment:

It is important to note that both of the above criteria must be satisfied for a supplier's substitution right to be substantive. In some instances, contracts contain clauses that give the lessor the right to substitute an asset; however, unless the lessor has a compelling reason to exercise that right, it is not substantive.

In addition, IFRS 16 requires the substitution right to exist throughout the period of use. If a substitution right were to only be exercisable upon the occurrence of a specific event, after a period of time had elapsed, or on a specific date, the substitution right would not be substantive for the purposes of IFRS 16 as it was not present throughout the period of use.

In situations where the asset is located at the lessee's premises or elsewhere away from the lessor, the cost to substitute the asset may outweigh any perceived benefit to the lessor. In addition, a supplier's right to substitute an asset for the purposes of repairs or maintenance (if the asset is not operating properly) or to be upgraded when a technical update becomes available, does not mean the lessor has a substantive right of substitution.

In situations where it is not readily determinable whether a supplier has substantive substitution rights, a lessee must presume that any substitution right is not substantive. This means that, in situations of doubt, lessees should assume that the contract contains a lease.

Example 4 – Lease of rail cars

A contract between Customer and Supplier requires Supplier to transport a quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of five years.

The timetable and quantity of goods specified are equivalent to Customer having the use of 10 rail cars for five years.

Supplier provides the rail cars, driver and engine as part of the contract.

The contract states the nature and quantity of the goods to be transported (and the type of rail car to be used to transport the goods).

Supplier has a large pool of similar rail cars that can be used to fulfil the requirements of the contract. Similarly, Supplier can choose to use any one of a number of rail cars to fulfil each of Customer's requests, and a rail car could be used to transport not only Customer's goods, but also the goods of other customers.

The cars are stored at Supplier's premises when not being used to transport goods.

Assessment

Supplier's **substitution rights in this example are substantive** because it:

- Has the practical ability to substitute the rail cars throughout the period of use, and
- Would benefit economically from substituting the rail cars because there is a large pool of them available and they are stored at its premises. Potential benefits to Supplier are deploying the rail cars to a nearby location for use in other contracts, or to use any of the 10 rail cars that are sitting idle for other purposes because they are not currently being used by Customer.

Therefore, although the contract makes use of identified assets (the rail cars), the **contract does not contain a lease** of those rail cars because Supplier has substantive substitution rights.

MORE EXAMPLES

The examples below illustrate both the above principles, i.e. there must be an identified asset and no substitution rights.

Example 5 – Cloud-based storage solutions

Company A entered into an agreement with Software Co for use of cloud-based storage solutions for various business units.

The term of the agreement is for three years, where Company A will pay $12,500 per month to Software Co.

The amount of computing power and storage capacity is for 10 tower server units whose serial numbers are specified in the agreement.

Any replacement of infrastructure must still satisfy minimum system specifications as noted in the contract between Company A and Software Co.

Assessment

The assets (servers) are specified in the arrangement because specified serial numbers for the servers are provided. The assets are explicitly noted in the contract.

While Software Co has the contractual right to substitute the assets, the replacement ones would have to meet minimum system specifications, and it is unlikely that Software Co would benefit economically from replacing the servers. As such, the substitution rights do not appear to be substantive.

Example 6 – Asset in a remote location

Company B's mining subsidiary needs electricity in a remote location, and has entered into a contract with Energy Co to purchase substantially all of the energy produced by its hydro-electric dam for a period of 10 years (the expected timeframe to exhaust the mine).

The electricity could be produced from other sources, but Energy Co would have no realistic alternative source to produce the power given it is in such a remote location.

Company B will pay Energy Co $25,000 per month over the 10-year period.

Assessment

The power plant is explicitly specified in the contract.

Energy Co can provide the power from alternative assets, however, the location is so remote that it would have no economically beneficial reason to substitute the asset for something else. The substitution rights are therefore not substantive.

Therefore, there **is an identified asset** in the contract.

ELEARNING MATERIALS

For more information, please refer to our IFRS 16 eLearning Materials which can be found on our website, specifically identifying a lease.

CONCLUDING THOUGHTS

Determining whether a contract is, or contains, a lease, is usually a straightforward matter. However, in practice, complex situations may arise that require the application of considerable professional judgement, particularly with respect to determining whether there is an identified asset. To enable such judgements to be made, finance teams will need to ensure that they are able to access all underlying contracts. If such contracts are not currently centrally stored, finance teams should commence the process of ensuring that all contracts are available for analysis well prior to the adoption of IFRS 16.

HOW WILL THE NEW FINANCIAL INSTRUMENT STANDARD IMPACT BUSINESS COMBINATIONS WHEN DETERMINING EXPECTED CREDIT LOSSES ON FINANCIAL ASSETS

Most entities will by now be applying the expected credit loss (ECL) requirements in IFRS 9 *Financial Instruments* when assessing whether financial assets that are at amortised cost, or debt instruments at fair value through other comprehensive income (FVTOCI), are impaired. However, it is important to note that when acquiring a business and applying IFRS 3 *Business Combinations*, acquirer groups will need to reassess, at acquisition date, the stages assigned by the acquiree when applying the new ECL requirements.

For financial assets acquired in a business combination, initial recognition occurs at the time of the business combination (acquisition date). This effectively means the status of most financial assets to which the new ECL model applies reverts back to Stage 1 on acquisition date in the books of the acquirer group. The exception is for acquired ‘Stage 3’ loans which are ‘purchased or originated credit-impaired financial assets’ at acquisition date where a separate impairment approach is applied.

WHICH FINANCIAL ASSETS REQUIRE IMPAIRMENT TESTING USING THE NEW ECL MODEL?

IFRS 9 requires the following types of financial assets to apply the new ECL requirements, i.e. debt instruments measured at:

- Amortised cost, or
- Fair value through other comprehensive income (FVTOCI).

HOW DO THE 'STAGING' PROVISIONS IN THE ECL MODEL WORK?

The IFRS 9 ECL model requires the above types of financial assets to be categorised into three ‘buckets’ as follows:

- Stage 1: Financial assets that have not had a significant increase in credit risk since initial recognition
- Stage 2: Financial assets that have had a significant increase in credit risk since initial recognition, or
- Stage 3: Credit-impaired financial assets.

The staging drives the measurement and disclosure requirements in the ECL model.

Since the relative change in credit risk since initial recognition is the mechanism for migration between these stages or ‘buckets’, ‘initial recognition’ must be considered carefully. For an acquirer, ‘initial recognition’ is the date of the business combination.

EXAMPLE 1

Big Co acquires Small Co on 1 July 2019.

Small Co has three loan receivables in its books on acquisition date (1 July 2019):

- Loan A (in stage 1)
- Loan B (in stage 2)
- Loan C (in stage 3, i.e. credit impaired).

The stages assigned above are based on the relative movement in credit risk experienced by Small Co since they were originated by Small Co prior to 1 July 2019.

From the Big Co Group's (acquirer) perspective, the date of initial recognition for these loans is 1 July 2019. This means that on initial recognition by the Big Co Group:

- Loan A remains in Stage 1
- Loan B reverts to Stage 1, and
- Loan C will be under the purchased or originated credit impaired approach (POCI) approach.

LOAN	IN BOOKS OF SMALL CO	BIG CO GROUP CONSOLIDATION
A	Stage 1	Stage 1
B	Stage 2	Stage 1
C	Stage 3	POCI approach

All loans will basically revert to 'Stage 1', except for Loan C, the acquired 'Stage 3' loan which is considered a 'purchased or originated credit-impaired' (POCI) financial asset at acquisition date.

IMPLICATIONS OF REASSESSING ECL STAGES

The requirement for the acquirer to reassess the ECL stages will result in several significant implications which may be complex to address in financial reporting systems:

1. Big Co Group's assessment of the staging of these loans will differ from Small Co's
2. In order to address the staging provisions, Big Co Group will need to develop policies and procedures to measure the relative movement in credit risk since the date of the business combination, and
3. The ongoing ECL required on the instruments may therefore differ as staging may differ (e.g. a 12-month ECL may be required for Big Co Group, but a lifetime ECL may be required for Small Co).

LOAN	IN BOOKS OF SMALL CO		BIG CO GROUP CONSOLIDATION	
A	Stage 1	12-month ECL	Stage 1	12-month ECL
B	Stage 2	Lifetime ECL (gross interest)	Stage 1	12-month ECL
C	Stage 3	Lifetime ECL (net interest)	POCI approach[1]	

1. POCI assets will need to follow the specific guidance in IFRS 9 which requires a credit-adjusted effective interest rate to be used. This rate builds ECL into the effective interest rate of the instrument, which may be complex to calculate and not easily achieved with current accounting systems and processes.

DON'T FORGET TO DETERMINE FAIR VALUE OF FINANCIAL ASSETS AT ACQUISITION DATE

As noted in our article in October 2019 Accounting News, prior to assessing the stages for ECL impairment calculations, the acquirer must also determine the fair value for each financial asset of the acquiree at acquisition date.

Even if both the acquiree and acquirer will each continue to measure a financial asset at amortised cost after the acquisition date, the acquirer will still have to recognise, at acquisition date, such financial asset at fair value. Changing the fair value at acquisition date will also result in the acquirer using a different effective interest rate to the acquiree.

PRESENTATION OF EXPECTED CREDIT LOSSES

Like most assets acquired in a business combination, financial assets acquired in a business combination that are subject to the ECL requirements of IFRS 9 are initially recorded at their fair value as at the date of the business combination. While ECL is a forward-looking measure with some similarities to fair value measurement, the concepts are not identical. Therefore, the net carrying value of financial assets may differ from their fair value.

EXAMPLE 2

Same facts as Example 1. Assume Loan B, which was originated by Small Co, at the date of the business combination (1 July 2019), had:

- A gross carrying value of $100, and
- A corresponding $20 ECL recorded against it, representing the **lifetime ECL** of the financial asset, as it is classified as a Stage 2 financial asset.

At the time of the business combination, Big Co determines the fair value of Loan B to be $78 (note that the fair value of a financial asset may be more or less than the gross carrying value less ECL depending on a number of factors).

No separate valuation allowance is recorded in the purchase price allocation by Big Co (IFRS 3.B41) because the fair value of the financial asset incorporates uncertainty regarding credit risk. The difference in classification and measurement of the financial asset from the perspective of Small Co and Big Co's consolidated records as at the time of the business combination can be demonstrated as follows:

LOAN B	BIG CO ($)	SMALL CO ($)
Gross carrying value	78	100
ECL balance	Nil	20
Net carrying value	78	80
Stage in ECL methodology	Stage 1 – 12-month ECL	Stage 2 – lifetime ECL

This results in not only the carrying value differing upon the completion of the business combination, but also the measurement of the ECL balance and the staging of the financial asset in the ECL guidance. Addressing these differences from a systems and process standpoint may be complex, especially if Big Co A and Small Co are required to maintain distinct financial records for reasons such as local jurisdictional regulation.

BDO MONTHLY WEBINARS – PLEASE REGISTER FOR 2019 WEBINARS NOW

Are you interested in an easy way to stay up to date with financial reporting and accounting standards which impact your business?

We invite you to register for our 2019 BDO Financial Reporting and Accounting standards live webinar series (11am to 12pm Sydney AEDT or AEST).

Remaining 2019 webinars are as follows:

DATE	TOPIC
November 2019	Accounting standards update: Getting ready for 31 December 2019
December 2019	Lessons learned from implementing IFRS 16

NEW BDO RESOURCES AND PUBLICATIONS

The IFRS Advisory section of our website contains a number of training resources and publications to help clients keep up to date on the latest developments in financial reporting.

TRAINING MATERIALS

The Accounting Standards Training page includes training materials on the 'triple threat' accounting standards, IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers and* IFRS 16 *Leases*, including:

- Interactive eLearning, and
- Webinars (one-hour video recorded presentations presented live on a monthly basis).

AUSTRALIAN DEVELOPMENTS

Our Australian Developments page collates resources on a variety of topics specific to Australian financial reporting, including:

- General purpose financial statements for significant global entities (SGEs)
- ASIC issues
- Corporate governance
- Not-for-profit entities, and
- Special purpose financial statements.

IFRS PUBLICATIONS

Our IFRS Publications page includes a range of publications on IFRS issues:

- Financial reporting standards updates (a summary of changes to accounting standards and other legislative changes impacting each June and December reporting season)
- Accounting news (monthly newsletters)
- Global IFRS resources, and
- Industry IFRS information.

COMMENTS SOUGHT ON EXPOSURE DRAFTS

At BDO, we provide comments locally to the Australian Accounting Standards Board (AASB) and internationally to the International Accounting Standards Board (IASB). We welcome any client comments on exposure drafts that are currently available for comment. If you would like to provide any comments please contact Aletta Boshoff at aletta.boshoff@bdo.com.au.

Document	Proposals	Comments due to AASB by	Comments due to IASB by
ED 295 *General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities*	Proposes a new Tier 2 disclosure framework for GPFS to replace RDR based on disclosures in *IFRS for SMEs*. The proposed framework will be referred to as Simplified Disclosures and will be included as a separate standard rather than by greying out unnecessary disclosures within the body of each Australian Accounting Standard.	30 November 2019	N/A
ED 296 *Disclosure of Accounting Policies* Proposed amendments to AASB 101 and AASB Practice Statement 2	The proposals have been drafted to assist preparers in applying the concept of 'materiality' when making accounting policy disclosures. Under the proposals: ▶ Only 'material' accounting policies are disclosed (rather than the current 'significant' requirement) ▶ Policies relating to immaterial transactions are not disclosed ▶ Not all policies relating to material transactions are themselves material, and therefore may not need to be disclosed ▶ Additional guidance is added to assist in determining if a policy needs to be disclosed.	28 October 2019	29 November 2019
ED 297 *Removal of Special Purpose Financial Statements for Certain For-Profit Private Sector Entities*	Proposes to remove the ability of the following types of for-profit private sector entities from being able to prepare special purpose financial statement from 2021: ▶ Those where legislation requires financial statements to be prepared in accordance with Australian Accounting Standards or 'accounting standards', and ▶ Those where constitutions or other documents (e.g. lending agreements) require financial statements to be prepared in accordance with Australian Accounting Standards, provided that document was created or amended on or after 1 July 2020.	30 November 2019	N/A

FOR MORE INFORMATION

ADELAIDE

PAUL GOSNOLD
Tel +61 8 7324 6049
paul.gosnold@bdo.com.au

BRISBANE

TIM KENDALL
Tel +61 7 3237 5948
timothy.kendall@bdo.com.au

CAIRNS

GREG MITCHELL
Tel +61 7 4046 0044
greg.mitchell@bdo.com.au

DARWIN

CASMEL TAZIWA
Tel +61 8 8981 7066
casmel.taziwa@bdo.com.au

HOBART

DAVID PALMER
Tel +61 3 6324 2499
david.palmer@bdo.com.au

MELBOURNE

DAVID GARVEY
Tel: +61 3 9603 1732
david.garvey@bdo.com.au

NEW SOUTH WALES

GRANT SAXON
Tel: +61 2 9240 9976
grant.saxon@bdo.com.au

PERTH

PHILLIP MURDOCH
Tel +61 8 6382 4716
phillip.murdoch@bdo.com.au