

THE BOTTOM LINE

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Welcome to the first edition of The Bottom Line, our quarterly newsletter that aims to keep you in the loop with all the latest accounting and financial reporting developments, and the potential impact they may have on your business.

In this edition, we focus on specific issues relating to the new financial instruments and revenue standards. We also provide a high-level overview of AASB 16 *Leases* and its potential impact on businesses, consider the recent clarifications regarding the treatment of uncertain tax positions and explain what is currently going on with respect to special purpose financial statements. We end off with recent accounting developments, both globally and locally.

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Investments in equity: to fvoci or not to fvoci?



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Under AASB 9, equity investments are normally measured at fair value through profit or loss (FVPL). This is because equity investments do not generally meet the 'solely payments of principal and interest' test required for amortised cost classification. There is, however, one exception to this rule. Entities can, on initial recognition, make an irrevocable election to present subsequent changes in the fair value of an investment in an equity instrument in other comprehensive income. This option applies to equity instruments that are not held for trading and are not contingent consideration of an acquirer in a business combination. The election is available on an instrument-by-instrument basis.

Entities may find the fair value through other comprehensive income (FVOCI) designation appealing as subsequent gains and losses (including any related foreign exchange gains and losses) on these instruments are recognised in other comprehensive income and not profit or loss. Dividends that represent a return on investment (as opposed to a return of investment) continue to be recognised in profit or loss. Cumulative gains and losses recognised in other comprehensive income are never subsequently reclassified from equity to profit or loss - even on disposal of the investment - meaning there is no need to review such investments for possible impairment.

Importantly, not all investments in 'equity' instruments qualify for FVOCI designation under AASB 9. To be eligible for FVOCI classification, the term 'equity instrument' uses the strict definition in AASB 132 *Financial Instruments: Presentation* which states that an equity instrument is "any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities". Under AASB 132, certain narrowly-defined categories of puttable instruments, and instruments repayable on a pre-determined liquidation, are required to be classified by the issuer as equity instruments because of an exception to the general definitions of financial liabilities and equity instruments. These instruments, however, do not actually meet the definition of an equity instrument and therefore the related asset cannot be designated at FVOCI by the holder.

AASB 9 Financial Instruments became effective for annual reporting periods beginning or after 1 January 2018 and replaced AASB 139 *Financial Instruments: Recognition and Measurement*.

This mainly relates to limited-life entities which may be required to be wound up after a certain period of time. Such an entity's limited life imposes an obligation, outside of the entity's control, to distribute all its assets. Similarly, professional partnerships may be required to be dissolved on the death or retirement of a partner imposing a similar obligation on the partnership. Other entities that rely on the exceptions to the general definitions of financial liabilities and equity instruments to classify their issued instruments as equity are open-ended mutual funds, unit trusts and some co-operative entities. Such entities often provide their unit holders or members with a right to redeem their interests in the issuer at any time for cash, a feature that would otherwise require classification as financial liabilities.

On the first-time application of AASB 9, entities have the opportunity to make designations in accordance with AASB 9. This includes, at the date of initial application, any investment in a non-derivative equity instrument that is not held for trading and is not contingent consideration of an acquirer in a business combination that may be designated as at FVOCI. The date of initial application is the date when an entity first applies the requirements of the new standard, which is the beginning of the period in which it first reports under AASB 9, not the earliest period presented as comparatives. Such a designation should be made on the basis of the facts and circumstances that exist at the date of initial application, including whether equity-type investments meet the definition of equity instrument at that date and whether equity instruments meet the definition of held for trading as if they had been acquired at that date.

What are your performance obligations?

With AASB 15 *Revenue from Contracts with Customers* now in play for most entities, implementation issues are coming to the fore for those entities that are only getting to grips with the standard now. The standard is detailed and complicated and by no means easy to apply, and many entities have underestimated the impact on their organisations.

Tackling the adoption of, and transition to, AASB 15 at the last minute means some entities may be tempted to bypass steps 1 to 4 of the new revenue recognition model and focus their efforts on step 5 – the timing of revenue recognition either at a point in time or over time. The problem with this approach is that revenue could be recognised inappropriately, and transition adjustments may be incorrect.

While all the steps in the new revenue recognition model are important, this article will focus on step 2 – identifying performance obligations. Not only is the transaction price allocated to the identified performance obligations (step 4), but revenue is recognised when, or as, a performance obligation is satisfied (step 5). Correctly identifying performance obligations is therefore fundamental to recognising revenue on a basis that faithfully depicts an entity’s performance in transferring promised goods or services to the customer.

How to go about identifying performance obligations

As a first step in identifying performance obligations in a contract, entities are required to identify, at contract inception, the promised goods or services in the contract. Often these are explicitly stated in the contract, however they also include promises implied by an entity’s customary business practices that create a valid expectation on the part of the customer that the entity will transfer a good or service. Conversely, administrative tasks or set-up activities that do not provide the customer with any incremental benefit are not performance obligations.

The second step after identifying the promised goods or services within a contract is determining which of those goods or services will be treated as separate performance obligations. That is, the individual units

of account need to be identified. Promised goods or services represent separate performance obligations if they are distinct. To be distinct, the following two criteria must be met:

- The customer can benefit from the good or service either on its own, or together with other resources that are readily available to the customer; and
- The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

For the first criterion above, a readily available resource is a good or service that is sold separately by the entity or another entity, or a resource that the customer has already obtained (either from the entity or from elsewhere). The fact that a good or service is regularly sold separately by the entity is an indicator that the customer can benefit from a good or service on its own or with other readily available resources.

Importantly, the assessment of whether a customer can benefit from the goods or services is based on the characteristics of the goods and services themselves instead of how the customer might use them.

Consistent with this notion, an entity disregards any contractual limitations that may prevent the customer from obtaining those readily available resources from another party when making this assessment.

Once it has been determined that a promised good or service is capable of being distinct based on the individual characteristics of the promise (criterion one), it must be established whether the promise to transfer the good or service is separately identifiable from other promises in the contract.

Five-step revenue recognition model in AASB 15





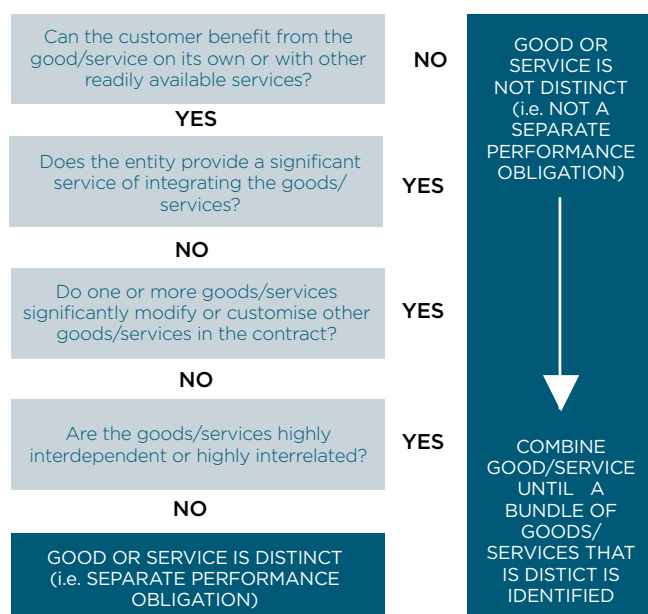
Let's look at two examples to illustrate the principles discussed.

When assessing whether a promise is separately identifiable from other promises in the contract, the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item (or items) to which the promised goods or services are inputs. This assessment is done from the perspective of the customer.

If a promised good or service is determined not to be distinct, an entity continues to combine it with other promised goods or services until it identifies a bundle of goods or services that is distinct. This may result in the entity accounting for all of the goods and services promised in a contract as a single performance obligation. Factors that indicate two or more promises are not separately identifiable include:

- The seller performs a significant amount of work to integrate the good or service with other goods or services promised in the contract;
- Goods or services provided are highly interdependent or interrelated; or
- One or more of the goods or services provided by the seller significantly modifies or customises, or is significantly modified or customised by, other goods or services promised in the contract.

The above thought process is presented in the decision tree below:



Example 1: Vendor X contracts with a customer to install a piece of machinery. The contract also includes maintenance services for a period of 12 months. The machine is operational without any customisation or modification. The installation is not complex and can be performed by alternative suppliers.

Based on the above, there are three promises in the contract, namely (1) the piece of machinery (2) the installation services and (3) the maintenance services. Starting at the top of the decision tree, the entity must assess whether each promised good or service is distinct. The entity determines that the customer can benefit from the machine on its own by using it or reselling it. The customer can also benefit from the installation services together with other resources that the customer will have already obtained from the entity (i.e. the machine) – the same logic would apply to the maintenance services.

In assessing whether the piece of machinery and the installation services are separately identifiable in the context of the contract, the entity considers the following (moving down the left side of the decision tree):

- Vendor X is not providing a significant integration service. The entity would be able to fulfil its promise to transfer the machine separately from its promise to subsequently install it. The entity has not promised to combine the machine and the installation services in a way that would transform them into a combined output.
- The installation services will not significantly customise or modify the machine as the customer can use the machine as is once delivered to the customer.
- The machine and installation services are not highly interdependent or interrelated because the machine and installation services do not significantly affect each other. Vendor X would be able to fulfil its promise to transfer the machine independently of its promise to do the installation.

On this basis, there are three performance obligations in the contract: (1) the piece of machinery (2) the installation services and (3) the maintenance services.

Note: if the customer was contractually obliged to use Vendor X to do the installation, the evaluation above would not change. This is because the contractual restriction does not change the characteristics of the goods or services themselves, nor does it change Vendor X's promise to the customer.

Example 2: Assume the same fact pattern as above except that, as part of the installation service, the machinery is substantially customised to add significant new functionality specific to the customer's needs. The customised installation can be provided by other suppliers.

In assessing whether the piece of machinery and the installation services are separately identifiable in the context of the contract, Vendor X considers the following:

- Vendor X is providing a significant service of integrating the modified machine into the customer's infrastructure by performing a customised installation service as specified in the contract. In other words, the entity is using the machine and the customised installation services as inputs to produce a combined output (i.e. functional and integrated customised machine).
- The machine is significantly customised and modified by the service to meet the requirements of the customer's needs.
- The machine and installation services are highly interdependent or interrelated because, within the context of the contract, the promise to transfer the machine is not separately identifiable from the customised installation services. Vendor X would not be able to fulfil its promise to transfer the modified machine independently of its promise to do the customised installation.

For the reasons above, Vendor X assesses that the machine and the installation services are not distinct. On this basis, there are two performance obligations in the contract: (1) customised installation service (that includes the modified piece of machinery) and (2) the maintenance services.

What if a warranty was provided under the contract in the examples? The nature of the warranty determines whether it is to be treated as a separate performance obligation. Assurance-type warranties promise that the delivered product is as specified in the contract and the estimated costs of satisfying the warranty are provided for in accordance with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*. A service-type warranty, on the other hand, provides customers with a service that goes beyond fixing existing defects in the product and would represent a separate performance obligation.

Final thoughts

Identifying performance obligations correctly is central to getting revenue recognition right. This assessment will be straightforward for some entities and more challenging for others, particularly entities in the construction, engineering, software and telecommunications sectors. Either way, entities are encouraged to take their contracts through the 5-step revenue model and document their judgements and considerations. This will most likely require increased collaboration between the finance team and those that draft the sales contracts to ensure the former understand the terms and conditions when applying AASB 15, and that the latter do not include terms and conditions in contracts that could have unintended accounting implications.

“Correctly identifying performance obligations is therefore fundamental to recognising revenue on a basis that faithfully depicts an entity's performance in transferring promised goods or services to the customer.”

The new leases standard at a glance

IFRS 16 (or AASB 16 in Australia) was first added to the International Accounting Standards Board’s agenda back in 2006. It was officially issued by the IASB in 2016. A standard that took a decade to develop can only mean one thing: big change.

The new leases standard became effective for annual reporting periods beginning on or after 1 January 2019. For lessees, it introduces a single model of lease accounting under which most leases will be brought on-balance sheet, meaning the distinction between operating and finance lease is no longer relevant. This distinction, however, still stands for lessors as lease accounting for lessors remains largely unchanged from the superseded standard.

Identifying a lease

AASB 16 defines a lease as 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. This definition looks quite straightforward at first glance but in practice it may be more challenging to apply, especially when the asset is not explicitly specified in the contract, or when the supplier potentially has a substantive right of substitution.

Often a contract will contain both a lease and the provision of other goods or services such as maintenance or cleaning. This will require the non-lease components to be identified and accounted for separately from the lease component. Lessees can, however, make an accounting policy choice (by class of underlying asset) to account for all the components as a single lease component. Lessees that do not make this policy election are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessors are required to apply AASB 15 to allocate the consideration in the contract.

Lessee accounting

A lease within the scope of the new standard will have to be recognised on the balance sheet as a right-of-use asset with a corresponding liability. There are two optional exceptions to this: low-value assets (those that cost USD 5,000 or less when new) and short-

term leases (those with a lease term of 12 months or less, including options to extend).

Calculation of the initial cost of the right-of-use asset includes the initial measurement of the lease liability. It is therefore necessary to start by measuring the lease liability.

Lease liability

At commencement date, the lease liability is measured at the present value of the lease payments to be made over the lease term.

Lease payments include:

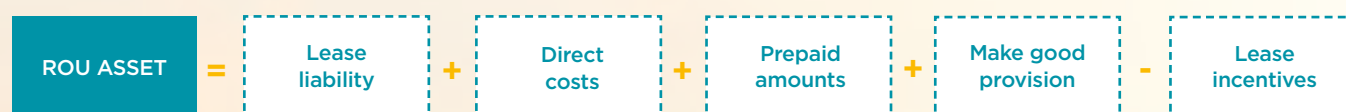
- Fixed payments less any lease incentives
- Variable lease payments that depend on an index or rate
- Expected payments under residual value guarantees
- The exercise price of a purchase option if the lessee is reasonably certain to exercise it
- Termination penalties if the lease term reflects the lessee exercising a termination option

Lease payments are discounted using the interest rate implicit in the lease, or if that cannot be readily determined, using the lessee’s incremental borrowing rate.

In subsequent periods, the lease liability is accreted to reflect interest and reduced to reflect payments made. Lessees are required to remeasure the lease liability upon the occurrence of certain events such as a change in the lease term, purchase options or residual value guarantees, or changes in rental amounts linked to an index or rate.

Right-of-use asset

The right-of-use asset is initially measured as follows:



The right-of-use asset is subsequently amortised to profit or loss. It is adjusted for impairment and any remeasurements of the liability resulting from the reassessment of the lease term, purchase options or residual value guarantees, or changes to variable lease payments linked to an index or rate that relate to future periods.

Transition for lessees

When applying the new standard for the first time, entities can adopt one of the following transition options:

- Full retrospective approach – apply the standard as if it had always been in effect (i.e. from the onset of each lease) and restate comparatives, adjusting opening retained earnings in the comparative year; or
- Modified retrospective approach – apply the standard only from the date of application, do not restate comparatives and adjust opening retained earnings at date of initial application.

Each option will have a different impact on the balance sheet and income statement on transition and therefore on future reporting. The transition choices will often involve a trade-off between cost and comparability i.e. the options and expedients that simplify and reduce the costs of implementation tend to reduce comparability of the financial information.

Implications for lessees

The impact on a lessee's financial statements will depend on the lessee's lease portfolio and which optional exemptions and practical expedients offered by AASB 16 lessees choose to apply. Generally speaking, lessees can expect:

- An increase in assets (right-of-use assets) and liabilities (lease liabilities) on the balance sheet
- A shift in lease expense classification from operating expenses to financing costs and depreciation/amortisation
- Front-loading of total lease expense in the earlier years of a lease despite constant cash rentals (as interest will decrease over time)
- An increase in their EBIT / EBITDA ratios given the lease expense (interest and depreciation) will be reported below the line
- A shift in cash flow classification as operating cash flows for lease payments will be replaced by financing cash flows for the reduction in the lease liability and operating or financing cash flows (depending on accounting policy) for interest

The impact of the new leases standard extends beyond just the financial statements. For example, entities will have to consider how their systems and processes will need to change to capture all the lease data, perform necessary calculations and keep all this information up to date for any modifications. Other matters to consider when adopting AASB 16 include:

- Bonus and executive remuneration arrangements
- Impairment testing and tax effect accounting considering the increase in assets and liabilities
- Debt covenants considering increased debt on the balance sheet and the changes to EBIT / EBITDA
- The entity's ability to pay dividends
- Future lease-versus-buy management strategies

Australian companies that are small under the Corporations Act should ensure that they continue to be small after adopting AASB 16 considering the additional assets being carried on the balance sheet. Large companies have a duty to lodge a financial report, a director's report and an auditor's report with the Australian Securities and Investments Commission each financial year, so it is important that companies get this assessment right. Currently, a large company is one that meets any two of the following three requirements:

- \$25 million or more in consolidated revenue
- \$12.5 million or more in consolidated gross assets, or
- 50 or more employees

As a reminder, Treasury has proposed to double the above thresholds for financial years commencing on or after 1 July 2019.

While this is a high-level overview of AASB 16, the standard is detailed and complex. To assist entities in understanding the new leases standard as they prepare to adopt it, we have created a leases series. The aim of the series is to break down AASB 16 into bite-size chunks, with each instalment focusing on a key aspect of AASB 16. To date, [Part 1: Definition of a Lease](#) and [Part 2: Lease Term](#) have been published and are available on our [website](#).



**THE NEW
LEASES
STANDARD
PART 1 & 2
AVAILABLE
NOW**

Uncertain tax treatments

Background

AASB 112 *Income Taxes* sets out the requirements for determining current and deferred tax assets and liabilities, which are applied based on applicable tax laws. There may be occasions when it is unclear how the tax laws will apply to a particular transaction, and the acceptability of the position taken by management will not be known until the tax authority takes a decision in the future. Prior to Interpretation 23, there was diversity in how entities dealt with such uncertain tax positions, with some entities referring to AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* for guidance despite AASB 137 not applying to income taxes. The new interpretation clarifies how to apply the recognition and measurement requirements of AASB 112 where there is uncertainty around income tax treatments.

Requirements of Interpretation 23

An uncertain tax treatment is any tax treatment applied by an entity where there is uncertainty over whether that treatment will be accepted by the relevant tax authority. For example, a decision to claim a deduction for a specific expense or not to include a specific item of income in a tax return is an uncertain tax treatment if its acceptability is uncertain under tax law.

Uncertain tax treatments are considered either individually or together with other uncertain tax treatments, depending on which approach better predicts the resolution of the uncertainty. Factors that an entity might consider in making this assessment include:

- How it prepares and supports the tax treatment; and
- The approach the tax authority is expected to take during an examination.

When recognising and measuring uncertain tax treatments, the probability of being subject to a tax examination is not taken into account. Where the relevant tax authority has a right to examine amounts reported to it, an entity should assume it will do so, and that when it performs the examination, the tax authority will have full knowledge of all related information.

If an entity concludes that it is probable (more likely than not) that the tax authority will accept an uncertain tax treatment, it should determine its tax position on that basis (i.e. there will be no change to amounts). On the other hand, if an entity concludes that acceptance of the uncertain tax treatment by the tax authority is not probable, it should reflect the

effect of the uncertainty in its income tax accounting in the period in which that determination is made. This could be done, for example, by recognising an additional liability or applying a higher tax rate.

The effect of any uncertainty is measured by using the method that best predicts the resolution of the uncertainty. The interpretation stipulates two methods in this regard:

- The most likely amount – the single most likely amount in a range of possible outcomes.
- The expected value – the sum of the probability-weighted amounts in a range of possible outcomes.

The most likely amount method might be appropriate if the possible outcomes are binary or are concentrated on one value. The expected value method might be appropriate if there is a range of possible outcomes that are neither binary nor concentrated on one value. Some uncertainties affect both current and deferred taxes (e.g. an uncertainty about the year in which an income is taxable). Interpretation 23 requires consistent judgements and estimates to be applied to current and deferred taxes.

Entities are required to reassess the judgements and estimates made around uncertain tax treatments when circumstances change or new information becomes available. New information might include actions taken by the tax authority, changes in tax rules, or the expiry of a tax authority's right to examine or re-examine tax treatment. The interpretation states that the absence of agreement or disagreement by a taxation authority with a tax treatment, in isolation, is unlikely to constitute a change in circumstances or new information that affects the entity's judgements and estimates.

No new disclosures are introduced by Interpretation 23 but entities are reminded of the need to disclose the judgements and estimates made in determining uncertain tax positions, as required under AASB 101 *Presentation of Financial Statements*.

Effective date and transition

Interpretation 23 is effective for annual periods beginning on or after 1 January 2019. An entity can elect to apply this interpretation either:

- retrospectively, restating comparatives by applying AASB 108 (if possible without the use of hindsight); or
- retrospectively, by adjusting retained earnings (or another component of equity) at the date of initial application with no restatement of comparatives.

The future of special purpose financial statements

In March 2018, the International Accounting Standards Board (IASB) issued the revised Conceptual Framework. This, in all probability, marked the beginning of the end for special purpose financial statements (SPFS) for entities that are required to prepare financial statements under Australian Accounting Standards.

Background

The *Conceptual Framework for Financial Reporting* sets out a comprehensive set of accounting concepts and is used primarily by the IASB in setting international accounting standards. It is also used by preparers of financial statements in understanding and interpreting the accounting standards and developing accounting policies for events or transactions to which no other current accounting standard applies. A revised version of the Conceptual Framework was issued in March 2018 by the IASB and will be effective for annual periods beginning on or after 1 January 2020.

For Australian Accounting Standards to remain compliant with international accounting standards (better known as 'IFRS'), the revised Conceptual Framework will have to be adopted in Australia. The problem, however, is that the revised Conceptual Framework introduces a new 'reporting entity' concept which is fundamentally different to the Australian 'reporting entity' concept contained in SAC 1 *Definition of the Reporting Entity* and referred to in each Australian Accounting Standard.

Entities such as listed entities, disclosing entities, registered managed investment schemes, APRA-regulated superannuation funds, and Australian Government, State, Territory and Local Governments are always considered to be reporting entities under AASB 1053 *Application of Tiers of Australian Accounting Standards*. These entities have to prepare general purpose financial statements (GPFS). The rest can essentially self-assess whether they are reporting entities or not using the guidance in SAC 1. Those deemed not to be reporting entities can prepare SPFS, allowing these entities to 'choose' the content of their financial reports that are intended for a limited number of users for a specific purpose. What is very often appealing about SPFS is that entities may avoid having to prepare consolidated accounts and making related party disclosures.

The inconsistency by entities in applying the reporting entity concept, and the ability of entities that are not deemed to be reporting entities to be selective about what they include in their financial statements, have undermined the fundamentals of consistency, comparability, usefulness and credibility of financial reporting in Australia. With the advent of the revised Conceptual Framework, the AASB felt that it was a good time to address the SPFS problem that is pretty much unique to Australia.

What does all this mean?

It is not ideal to have two 'reporting entity' concepts in Australia. Given that we conform to IFRS, SAC 1 would be withdrawn in order for the revised Conceptual Framework to be adopted in Australia. Entities required to prepare financial statements that comply with Australian Accounting Standards would then no longer be able to prepare SPFS.

SAC 1

Reporting entities are all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

Revised Conceptual Framework

A reporting entity is one that is required, or chooses, to prepare financial statements.

The AASB's preferred approach for adopting the revised Conceptual Framework and dealing with the SPFS issue is as follows:

Phase 1: Short-term approach (effective from 1 January 2020)	<ul style="list-style-type: none"> • Apply the revised Conceptual Framework in Australia to all <i>for-profit private sector</i> entities that have public accountability, and other for-profit entities who voluntarily comply with IFRS • Continue to apply the existing Conceptual Framework and use the Australian reporting entity concept for all other entities
Phase 2: Medium-term approach (effective after 2021)	<ul style="list-style-type: none"> • Apply the revised Conceptual Framework to all <i>for-profit private sector</i> entities that have a statutory requirement to comply with Australian Accounting Standards • Remove SAC 1 <i>Definition of the Reporting Entity</i> and amend Australian Accounting Standards to remove the Australian reporting entity concept for all for-profit private sector entities • Replace SPFS with a Tier 2 framework

The Tier 2 framework that will replace SPFS will be a brand new framework (i.e. not the Tier 2 GPFS Reduced Disclosure Requirements we currently know), but will still require compliance with all recognition and measurement requirements in Australian Accounting Standards, including consolidation and equity accounting. Disclosure requirements under the replacement framework are still currently being debated.

For not-for-profit private sector entities, the approach to removing SPFS depends, to some degree, on the outcome of the ACNC legislative review. The AASB therefore decided that phases 1 and 2 would only cover the for-profit private sector. An appropriate financial reporting framework for not-for-profit private sector entities will be considered and addressed by the AASB separately. There has been suggestion that we could end up with three tiers of reporting for NFPs, with the lowest tier being on a cash accounting basis.

The framework for public sector entities will also be considered separately by the AASB, with outreach activities planned to start in due course.

Who will be impacted?

Entities that will be most impacted by the proposed changes would be those that:

a) are required by legislation to prepare financial statements under Australian Accounting Standards; and

b) currently prepare SPFS without applying all recognition and measurement principles of Australian Accounting Standards, including consolidation and equity accounting.

Ramping up financial statements from SPFS to GPFS for the above entities might prove challenging and may require significant time, effort and cost. The AASB has undertaken to consult extensively with stakeholders and regulators to understand what transitional relief may be required to alleviate the additional reporting burden for those entities and other entities required to step-up their reporting requirements.

Where are we at currently?

After extensive consultation processes on phases 1 and 2 last year, the proposed standard which would formalise phase 1 is in the final stages of being approved and issued by the AASB. Once issued, it would be effective for annual reporting periods beginning on or after 1 January 2020, alongside the revised Conceptual Framework.

The AASB is proceeding with phase 2 and an Exposure Draft in this respect is expected to be released in the second half of this year. The application date for phase 2 is unknown at this stage but it is unlikely to be before 2021.

ASIC review findings for 30 June 2018 financial reports

On 25 January 2019, the Australian Securities and Investments Commission (ASIC) announced the results from its review of 30 June 2018 financial reports of listed and other public interest entities.

Of the 215 financial reports reviewed, ASIC made enquiries of 55 entities regarding 79 accounting-related matters. This compares to 220 financial reports reviewed under the 30 June 2017 cycle that resulted in 50 entities having to explain the accounting treatment of a total of 54 matters.

The majority of ASIC's findings continue to relate to impairment of non-financial assets. Directors are reminded of their responsibility to understand their company's financial report. This includes questioning the need for, and adequacy of, asset impairment, and the adequacy of related disclosures. ASIC's Information Sheet 203 *Impairment of non-financial assets: Materials for Directors* ([INFO 203](#)) provides guidance to assist directors and audit committees in considering whether the value of non-financial assets reflected in a company's financial report continue to be supportable.

Findings related to revenue recognition more than doubled from 2017 to 2018. It is expected that ASIC will continue to focus on this area considering the new revenue standard, AASB 15, is now in play for all for-profit entities.

The number of findings per accounting-related matter for 2017 and 2018 are graphically presented below.

Not all enquiries made of individual entities necessarily lead to material restatements. ASIC noted in its media release that 13 of the entities had no change to their 2018 financial reports. ASIC does not pursue immaterial disclosures that may add unnecessary clutter to financial reports.

For ASIC's full media release (MR 19-014), please [click here](#).

Matter	Number of findings	
	2018	2017
Impairment	28	20
Revenue recognition	18	8
Tax accounting	11	8
Expense deferral	3	4
Business combinations	3	3
Consolidation accounting	4	2
Operating segments	0	2
Other	12	7

“It is expected that ASIC will continue to focus on revenue recognition considering the new revenue standard, AASB 15, is now in play for all for-profit entities.”

Onerous contracts - proposals to clarify 'costs of fulfilling a contract'

The International Accounting Standards Board (IASB) has recently issued the Exposure Draft *Onerous Contracts - Cost of Fulfilling a Contract* in which it clarifies and provides guidance on what is meant by 'costs of fulfilling a contract' when assessing whether a contract is onerous under IAS 37 (AASB 137 in Australia). The clarifications may affect construction, manufacturing and service companies more so than others.

Background

Relevant definitions under IAS 37:

Onerous contract	Unavoidable costs
A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.	The lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it.

A contract can be onerous from the very beginning or can become onerous when circumstances change and expected costs increase or expected benefits decrease.

Under IAS 37, once a contract is assessed as being onerous, the entity is required to recognise a provision for the loss it expects to incur on the contract.

The standard is silent on which costs to include in determining the cost of fulfilling a contract. Specifically, it does not specify whether the cost of fulfilling a contract comprises only the incremental costs of fulfilling that contract, or instead also includes an allocation of other costs that relate directly to the contract. The lack of guidance on this matter has resulted in diversity in accounting for onerous contracts.

More recently, IAS 11 *Construction Contracts* (AASB 111) was recently withdrawn and replaced by IFRS 15 *Revenue from Contracts with Customers* (AASB 15). The superseded standard specified which costs entities should include when identifying an onerous contract provision for contracts that were within its scope. IFRS 15, however, does not include any equivalent guidance on onerous contracts. As a result, entities will most likely look to IAS 37 for guidance when accounting for onerous contracts, meaning the potential for reduced comparability if these companies have different interpretations on the application of IAS 37.

The proposed changes

The proposed changes would amend IAS 37 to specify that in assessing whether a contract is onerous, the cost of fulfilling the contract comprises costs that relate to the contract.

Proposed examples of such direct costs include:

- Direct labour
- Direct materials
- Allocations of costs that relate directly to contract activities (such as depreciation of assets used in fulfilling the contract)
- Costs explicitly chargeable to the customer under the contract
- Other costs incurred only because an entity entered into the contract

General and administrative costs would be excluded under the proposed amendments as they do not relate directly to the contract unless they are explicitly chargeable to a counterparty under the contract.

Transition and effective date

The IASB proposes that an entity applies the amendments to contracts existing at the beginning of the annual period in which the entity first applies the amendments. An entity would not restate comparative information and would instead recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the start of the period when they are first applied.

The effective date will be determined when the final amending standard is issued by the IASB. Application of the amendments before the effective date would be permitted.

The Australian Accounting Standards Board is requesting comments by 22 March 2019, and the International Accounting Standards Board by 15 April 2019. Interested parties are encouraged to submit their comments.

New definition of 'business'

There has recently been a change to the definition of 'business' in AASB 3 *Business Combinations* via amending standard [AASB 2018-6 Amendments to Australian Accounting Standards – Definition of a Business](#). The new definition must be applied to acquisitions occurring during the first annual reporting period beginning on or after 1 January 2020.

The standard narrows the definition of 'business' and 'outputs' to focus on returns from selling goods and services to customers, rather than on cost reductions. It also clarifies that to be considered a 'business', an acquired set of activities and assets must include, as a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs.

The revised definition is expected to assist preparers in determining whether a transaction should be accounted for as a business combination or as an asset acquisition. This distinction is important as a business combination gives rise to goodwill whereas an asset acquisition does not.

New definition of 'material'

The definition of 'material' in AASB 101 *Presentation of Financial Statements* and AASB 108 *Accounting Policies, Changes in Estimates and Errors* has been refined to assist entities in making judgements about whether information is material for inclusion in the financial statements.

Old Definition	New Definition
Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements.	Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

How entities make materiality judgements is not expected to change significantly as the refinements are not intended to alter the overall concept of materiality. However, the refined definition, and the guidance and improved explanations that now accompany the definition of material in AASB 101, will hopefully make it easier for entities to understand and apply this important concept. Entities are encouraged to refer to [Practice Statement 2: Making Materiality Judgements](#) for extensive guidance on applying the concept of materiality when preparing general purpose financial statements.

The new definition applies prospectively for annual periods beginning on or after 1 January 2020. Earlier application is permitted, however entities that choose to apply the amendments earlier must disclose this fact.

Not-for-Profits: Deferral of requirement to fair value peppercorn leases

[AASB 2018-8 Amendments to Australian Accounting Standards – Right-of-Use Assets of Not-for-Profit Entities](#) was officially approved by the AASB late last year, and amends AASB 16 *Leases* by providing a temporary option for Not-for-Profit (NFP) lessees to elect not to measure right-of-use (ROU) assets arising from leases that have significantly below-market terms and conditions principally to enable the entity to further its objectives. Such leases are referred to as 'concessionary leases' and include peppercorn leases.

The standard allows for two measurement options at initial recognition of concessionary leases:

- Cost; or
- Fair value

If the cost option is elected, the ROU asset will initially be recognised based on the value of the lease liability (present value of future lease payments). Note that the election is applied to ROU assets on a class-by-class basis.

AASB 2018-8 is effective for annual periods beginning on or after 1 January 2019, which is the effective date of AASB 16 *Leases* and AASB 1058 *Income of Not-for-Profit Entities*.

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