# IFRS Perspectives

## Update on IFRS issues in the US

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## Non-GAAP financial measures are thriving

### Thriving, but limited consistency

When properly used, non-GAAP financial measures (NGFMs) – also sometimes referred to as alternative performance measures (APMs) outside the United States – supplement the GAAP information to provide investors with relevant and useful additional information about a company's financial performance, financial condition or cash flows and liquidity. However, due to a lack of guidance, there is diversity in the use, presentation and reporting of these measures amongst preparers.

### Non-GAAP financial measures under IFRS

NGFMs are not prohibited by IFRS, and therefore it is not uncommon for IFRS preparers to present NGFMs; for example, on the income statement as well as in the notes to the financial statements.

Certain IFRS require the disclosure of financial information as reported by management, such as segment information reported to the chief operating decision maker (regardless of the IFRS measurement of those amounts) or information regarding regulatory capital for financial institutions. Such disclosures are not considered NGFMs.

In addition, IFRS permits companies to present additional line items, headings and subtotals when such information is pertinent for users to understand the company's financial position or performance. For example, management may conclude that EBITDA (earnings before interest, tax, depreciation and amortization) is relevant to understanding the company's financial performance, perhaps due to significant debt covenants that are evaluated based on this measure. Under IFRS, the company could present EBITDA as a subtotal and disaggregate its components as additional line items on the face of the income statement.

The additional subtotals or headings should:

- comprise line items made up of amounts recognized and measured in accordance with IFRS;
- be presented and labeled in a manner that makes the line items that constitute the subtotal clear and understandable;
- be consistent from period to period;
- be displayed with no more prominence than the subtotals and totals presented in the balance sheet or income statement that are specifically required by IFRS (e.g. profit or loss); and
- for the income statement, be reconciled with the amounts and totals specifically required by IFRS.

### Non-GAAP financial measures in the US and implications for foreign private issuers

US GAAP provides baseline presentation guidelines for the primary financial statements. Like IFRS, US GAAP requires the disclosure of segment information reported to the chief operating decision maker (regardless of the GAAP measurement of those amounts). Such disclosures are not considered NGFMs.

In the United States for SEC registrants, the presentation of NGFMs is governed by SEC regulation and interpretive guidance issued by the SEC staff.[1] NGFMs are prohibited in financial statements filed with the SEC, but they are permissible outside the financial statements (e.g. in the MD&A). Registrants also disclose NGFMs in other public disclosures, such as press releases, earnings calls and on their websites.

As an exemption from the general prohibition on NGFMs being presented in the financial statements, the SEC permits a FPI to use a NGFM in a filing with the SEC if that measure:

— relates to the GAAP (e.g. IFRS) used in the registrant's primary financial statements included in its filing with the SEC;

— is required or expressly permitted by the standard setter that is responsible for establishing the GAAP used in such financial statements (e.g. the IASB); and

— is included in the annual report prepared by the registrant for use in the jurisdiction in which it is domiciled, incorporated or organized or for distribution to its security holders.[2]

If the FPI applies this exemption, it still needs to define the measure and reconcile it to the most directly comparable GAAP measure, giving equal prominence to that directly comparable GAAP measure.

To be 'expressly permitted', there needs to be an explicit acceptance of that NGFM by the standard setter (e.g. the IASB for IFRS), or the regulator in the FPI's home country. This may be evidenced through actions such as a published view or correspondence from that regulator to the FPI indicating acceptance of the presentation.[3]

This exemption does not cover situations where the NGFM is merely 'not prohibited' by the IASB. Therefore, even though EBITDA can be presented on the face of the income statement if certain conditions are met (see above), it is unclear whether that presentation is 'expressly permitted' absent an explicit acknowledgment from the IASB or local regulators, and therefore permissible in documents filed with the SEC.

### More latitude under IFRS, but not a free-for-all

The key message for the use of NGFMs by IFRS preparers is that there is more scope for their usage than under US GAAP. However, as shown in this article, it would be a mistake to think that management has free rein to mold its NGFMs without regard to the IFRS measures reported in the financial statements.

## Brexit: IFRS considerations for US companies

In March 2017, the UK activated Article 50 of the Lisbon Treaty, thereby commencing its exit from the European Union (EU). In April, the announcement of early elections in the UK showed the continued unpredictability related to the UK's June 2016 referendum on Brexit. During periods of such heightened uncertainty and related market volatility, users will look for information in the financial statements and broader corporate reporting to better understand the effects these conditions could have on a company's performance and to understand the actions taken by management to respond to the risks.

### Measurement of assets and liabilities under IFRS

Uncertainty and volatility put particular pressure on the financial statement measures and related disclosures for items such as noncurrent nonfinancial asset and financial asset valuations, inventory values, potentially onerous contracts, deferred tax asset recognition, recoverability of receivables, hedge effectiveness, defined benefits obligations, and even the going concern assessment and covenant compliance.

Perhaps the greatest focus remains on asset impairment tests under IAS 36, *Impairment of Assets*, which require numerous factors to be considered.

— Brexit gives rise to many potential triggering events, including the British pound's sharp fall against the US dollar, and decisions to relocate;

[1] Regulation G and Regulation S-K Item 10(e), and Compliance and Disclosure Interpretations (C&DIs).

[2] Regulation S-K Item 10, Note to paragraph (e).

[3] C&DI 106.01.

— cash flow projections with uncertainty about long-term implications, including inflation and growth rates; and

— risk premiums in discount rates and the effect of low interest rates in the UK.

## Brexit monitoring activities

Management should conduct a robust evaluation of how the developments may affect their operations, including a comprehensive assessment of the risks and uncertainties they may be exposed to. This evaluation might comprise:

— continuously evaluating the company's exposure to UK and EU markets;

— monitoring guidance provided by the SEC and other regulatory bodies related to Brexit;

— assessing the effect of decisions made by the UK government, EU and Central Banks on the company's operations and accounting; and

— reviewing and evaluating disclosures periodically to ensure these are up to date, consistent, entity-specific and in accordance with the requirements of IFRS.

Because of the volatility in the British pound, preparers should monitor whether using an average exchange rate for translating foreign currencies as allowed by IAS 21, *The Effects of Changes in Foreign Exchange Rates*, remains appropriate.

## Income tax impact

The UK currently operates under EU tax treaties for transactions with EU and non-EU countries. It is unclear which tax laws will apply after Brexit. Therefore, US companies with significant UK operations, which have benefited or are currently benefiting from various tax exemptions related to EU legislation because of the UK membership, may be affected.

Considering the unprecedented nature of the circumstances and the related uncertainty, the possible changes in the UK's tax status should not be accounted for until the uncertainty is resolved. However, in the meantime, if material, a company should provide meaningful disclosures in its financial statements (or interim financial reporting) of the uncertainty about the effect of the UK leaving the EU.

## Other Brexit-related disclosures

For companies that may be significantly affected by Brexit, the financial statements need to provide appropriate/enhanced disclosure so users are able to understand the effects of the events on the company's financial position and cash flows – in particular, disclosure of risks, significant judgments and key assumptions in the financial statements.

As a reminder, IFRS requires disclosure of the following (not exhaustive).

— IAS 1, *Presentation of Financial Statements*. Estimation uncertainties, assumptions about the future and other judgments relevant to assets and liabilities in the financial statements and information about managing capital. Disclosure is required for any material uncertainties that may cast significant doubt on an entity's ability to continue as a going concern, and when management concludes that there are no material uncertainties but reaching that conclusion involves significant judgment (a 'close call' scenario).

— IAS 10, *Events after the Reporting Period*. Updates about conditions at the end of the reporting period and nonadjusting events after that date.

— IAS 36, *Impairment of Assets*. Assumptions and sensitivities related to the impairment testing of nonfinancial assets.

— IFRS 7, *Financial Instruments*: *Disclosures*. Risks arising from financial instruments during and at the end of the period and how the entity manages those risks, including credit, liquidity and market risks.

— IFRS 13, *Fair Value Measurement*. Assumptions underlying fair value measurements when there is no active market.

The risk factors have led to increased risk disclosures with respect to forward-looking estimates and fair values. Furthermore, companies with significant UK operations have been providing more extensive risk disclosures in relation to the uncertainties and increased volatility as well as details about the potential effect of Brexit on their business models. Given the ongoing developments, this may require a company to update its disclosures to provide changes to its risk factors each quarter under IAS 34, *Interim Financial Reporting*.

The common risk factors expected in risk disclosures can be summarized as follows.

— **Exchange rate**. Effect of currency volatility on business and operations.

— **Economic environment**. Risks to current business models due to economic slowdown in the UK and/or higher inflation.

— **Legal and regulatory uncertainty**. Incremental risk from regulatory changes for heavily regulated industries (e.g. financial services, pharmaceutical and telecommunications) or companies relying on UK trademarks or patents.

— **Political uncertainty**. Besides the developments in the UK, (upcoming) elections in other Member States show calls for withdrawal or renegotiation with the EU.

— **Other potential risks**. Other (operational) risks may arise from limiting the freedom of movements of capital, people, labor and goods between the UK and the EU member states.

### Specific considerations for foreign private issuers

FPIs are expected to include supplementary disclosures in their MD&A as part of their annual filings and interim information (when interim information is provided in the FPIs' home countries). These supplementary disclosures focus on trends in operations and principal business risks and uncertainties, and their scope in the MD&A is generally broader and more forward-looking than information included in the financial statements. Determining which disclosures are appropriate requires consideration of what is important in the context of the company and its operations.

**Sources:**

— European common enforcement priorities for 2016 financial statements. Public statement, ESMA; October 28, 2016

— Annual Review of Corporate Reporting 2015/2016. UK Financial Reporting Council (FRC); October 2016

— Brexit: Financial reporting implications. Audit Committee Institute, KPMG; July 2016

## IFRS 15: Our five tips for a successful implementation

Implementing IFRS 15, *Revenue from Contracts with Customers*, is the 2017 hot topic for many IFRS preparers in the run-up to the January 1, 2018 effective date for calendar year-end companies. In a December 2016 survey among financial reporting executives,[1] two-thirds of their organizations remained in the assessment phase. Respondents cited resource constraints, system gaps and other issues that have impeded their progress.

One of the factors of prolonged projects has been the volume and complexity of technical challenges identified when trying to apply the final standard to a diverse array of transactions – this was foreseeable, but no less disruptive. Accounting interpretation has been building fast since the standard was published. This process has helped preparers overcome many of the issues, though some are still open today. Further application challenges may yet be identified.

With fewer than seven months remaining before the effective date of IFRS 15, there is an urgent need to move on to the implementation phase – technical issues awaiting a final answer should no longer delay implementation.

Recognizing that their final approach may change as interpretations and the opinions of their regulators develop, IFRS 15 adopters need to be prepared to adopt preliminary positions on challenging technical issues. Building as much flexibility as possible into any solution adopted on the basis of this preliminary position and continuing to monitor relevant interpretations and the views of their regulators is key. By doing this, preparers can put the bulk of the assessment phase behind them and move on to the implementation phase.

As complicated as the assessment phase has proven to be, the implementation phase brings with it a new set of complexities and challenges and, given the rapidly approaching adoption date, these need to be overcome as efficiently as possible. With that in mind, we've developed the following list of top priorities when moving toward full adoption of IFRS 15.

[1] KPMG's Accounting Change Survey of more than 475 financial reporting executives in the United States; December 2016.

1. **Use a holistic assessment approach**
IFRS 15 represents much more than a change in technical accounting guidance. The requirements of the standard have broad ranging implications for technology, data requirements, processes, controls and reporting. While many companies have delved into the accounting gaps that will affect their business, many assessments have not considered the additional company-wide effects and process overhaul required to adopt IFRS 15.

   **Our tip:** As a gap assessment is the foundation for the subsequent design and implementation phases, a holistic perspective in this phase will facilitate an effective, efficient and sustainable adoption of IFRS 15. A smooth transition starts with a holistic assessment of the business-wide effects of the standard. It's not too late to start or refine your revenue gap assessment process.

2. **Identifying distinct performance obligations**
IFRS 15 requires entities to assess their revenue streams and underlying contracts to determine what distinct performance obligations are present. A performance obligation is distinct when the good or service is *capable* of being distinct and is distinct within the context of the contract. Companies have encountered significant difficulty related to judgments for determining whether a performance obligation is distinct.

   **Our tip:** Identifying distinct performance obligations timely for each revenue stream is integral to the new five-step revenue model, because this influences the determination of transaction price, how the transaction price is allocated to the performance obligations, and the timing of revenue recognition.

3. **Estimating variable consideration**
The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. To determine the transaction price under IFRS 15, entities are required to estimate the variable consideration to be received, subject to a constraint. Many companies have underestimated the incremental effort required to do this. Current technology and policies may not be capable of making such estimations or updating them on a continuous basis.

   **Our tip:** A few examples where variable consideration should be estimated are construction contracts with performance bonuses tied to specified finish dates, or commission fees earned as an agency places media for a customer. As this number will be audited and incorporates forward-looking estimates, many companies have used this requirement to refine their budget and forecasting processes to align with the expectations established under IFRS 15.

4. **Selecting a transition method**
IFRS 15 provides alternative transition methods for adopting the new standard. Many companies we've talked to initially preferred a full retrospective approach for adoption, which would show all comparative periods restated in compliance with IFRS 15. On becoming more familiar with the implications of each transition method, many companies have revisited this decision and are opting for the modified retrospective approach. While less cumbersome from a historical presentation perspective, this option still requires a cumulative catch-up adjustment and disclosures supporting those calculations at a level of disaggregation not previously presented. Additionally, companies will need to consider their approach for transitional discussions in the MD&A section of their annual report when comparing year-over-year numbers under two sets of standards.

   **Our tip:** It is crucial to have a clear understanding of the options available and their underlying implications, as this provides a backdrop for all assessment, design and implementation phase activities as you move toward full compliance.

5. **Disclosures are integral to the assessment and implementation**
One of the objectives of the new revenue standard is to provide more useful information to users of financial information through improved disclosures. Most of the disclosure requirements for IFRS 15 are new. Two of these disclosures may be particularly challenging because they require data not previously recorded, thereby creating a need for a system approach:

   — remaining performance obligation; and

   — disaggregation of revenue.

   **Our tip:** Prioritizing these disclosures will enable you to have a more robust understanding of the data and process changes necessary to comply with IFRS 15. In addition, by viewing the disclosures from an investor's perspective, you will be better equipped to communicate the effects of the standard during the transition period. IAS 8, *Accounting Policies*, *Changes in Accounting Estimates and Errors*, requires disclosures on forthcoming accounting standards that have not yet been adopted to be included in the notes to the financial statements.

The implications of adopting IFRS 15 are proving to be challenging given the scope and breadth of its effect within an organization. We hope that the above five practical tips will help you further navigate through the process of a successful and timely implementation.

## IFRS combined and/or carve-out financial statements

US GAAP combined and/or carve-out financial statements have long been used in the United States for capital market transactions, including in filings with the SEC. But the uptick in demand for such financial statements under IFRS is a newer development. Likewise, cross-border private M&A transactions involving foreign or US-based businesses often require the preparation of IFRS financial information.

In May 2015, the IASB reinforced in Exposure Draft, *Conceptual Framework for Financial Reporting*, its acknowledgment that combined and/or carve-out financial statements can comply with IFRS. One aspect of compliance is that the combined and/or carve-out financial statements need to be relevant, useful and representationally faithful. However, judgment is required in a number of areas, because there is no specific IFRS literature defining or providing guidance related to such financial information.

We have observed diversity in practice; this makes the preparation of combined and/or carve-out financial statements challenging for a company's processes and can require considerable judgment by management.

Here we highlight key accounting areas requiring judgment when a company is preparing combined and/or carve-out financial statements. These and more are covered in greater detail in KPMG's recently published guide, Combined and/or carve-out financial statements, which summarizes common practices as well as the main issues and challenges in preparing such financial statements under IFRS.

1. **Boundaries of the combined and/or carved-out entity.** The entity is tailored to meet the specific purpose for which the financial statements are prepared. Management needs to identify all relevant economic activities that form part of the combined and/or carved-out entity. For example, the purpose of the combined and/or carve-out financial statements could be to display management's track record in conjunction with conducting an IPO for a portion of a larger business. Applying these principles also requires consideration of local regulatory requirements.

2. **Top-down vs. bottom-up approach.** The combined and/or carve-out financial statements can be compiled using either:
   - a 'top-down approach', in which the information is extracted from the consolidated financial statements of the larger reporting entity; or
   - a 'bottom-up approach', in which the financial statements for the carved-out entity are built up entirely from the legal entity's ledgers.

   In selecting one or the other, consideration should be given to whether the information can be reliably and efficiently extracted from the larger reporting entity, as well as the requirements and preferences of local regulators.

3. **Related party transactions.** The accounting for transactions between the larger reporting entity and the combined/carved-out entity – e.g. leases, shared services centers, intra-group financing – needs to reflect the perspective of the combined and/or carved-out entity rather than the group as a whole. Those transactions may be charged at fair value. Alternatively, the price may be based on an intra-group formula that is not on an arm's-length basis. IAS 24, *Related Party Disclosures*, does not establish any measurement requirements for related party transactions. In our experience, a company chooses one of two approaches: (1) applying the relevant standard or, where a transaction with shareholders is identified, the transaction might be measured at fair value; or (2) allocating the actual costs incurred by the larger reporting entity on a systematic and rational basis to the combined/carved-out entity, regardless of whether an amount is charged or whether the actual costs reflect fair value.

4. **Financing.** Combined and/or carve-out financial statements prepared using the planned financing structure usually constitute pro forma information because the financing is not in place prior to closing of the proposed transaction. Rather, the financial statements should reflect the historical financing of the combined and/or carved-out entity. Internal financing between the larger reporting entity and the combined/carved-out entity is assessed under the relevant financial instruments standard, IAS 39 or IFRS 9. Classification as liability or equity may require judgment when there are no stated repayment terms.

5. **Shared assets.** Intangible assets, property, plant and equipment, etc. may be shared between the combined and/or carved-out entity and the larger reporting entity. Judgment is required to determine whether those shared assets should be recognized entirely, partially or not at all in the combined and/or carve-out financial statements.

6. **Bonus payments.** Bonus payments conditioned upon a successful carve-out related to management or employees working at the level of the combined/carved-out entity may need to be reflected in the combined and/or carve-out financial statements. If these cost are directly attributable to the combined/carved-out entity, IFRS 2, *Share-based Payment*, or IAS 19, *Employee Benefits*, may apply depending on the facts and circumstances.

7. **Transaction costs.** Some transaction costs may be specifically attributable to the combined and/or carved-out entity. Examples of costs to assess include issuance costs for financial instruments, costs for legal advice and consulting fees.

8. **Subsequent events.** Generally, the 'first-time adopter approach' is applied in conjunction with IFRS 1, *First-time Adoption of IFRS*. Under this approach, estimates made under previous GAAP are generally not revised for information received at a later date.

9. **Income tax.** Income tax in a tax-consolidated group may be allocated as follows:
   - current and deferred income taxes are recognized by each entity in the group, regardless of who has legal liability for settlement/recovery of the tax; or
   - each entity recognizes current income taxes based on the amounts actually paid by the individual legal entities.

Further consideration is needed when components of the combined and/or carved-out activity are not considered separate entities for tax purposes.

Preparing IFRS combined and/or carve-out financial statements is a complex undertaking that can create practical challenges for management from project management, IT systems and data gathering, central and shared services, to internal controls. Talk to your KPMG professional to understand specific considerations relevant to your situation.

## IFRS vs. US GAAP: Liability/equity classification

Capital structures can be complex, containing a number of features and performance characteristics. Classification of a financial instrument as financial liability or equity under IFRS can be challenging. Also, IFRS differs from US GAAP in this area and their respective requirements can be easily confused.

The general principles that drive the classification of a financial instrument as a financial liability or as equity under IFRS are outlined below.

### Basic liability/equity classification requirements under IFRS

Under IAS 32, *Financial Instruments: Presentation*, a financial liability is defined as a contractual obligation to transfer cash or another financial asset. A financial instrument is also classified as financial liability if it will or may be settled in a variable number of the entity's own equity instruments. A non-derivative contract that will be settled by an entity delivering its own equity instruments is an equity instrument if, and only if, it will be settled by delivering a fixed number of its own equity instruments. A derivative contract that will be settled by the entity delivering a fixed number of its own equity instruments for a fixed amount of cash is an equity instrument. Certain exceptions exist for several instruments including preference shares and puttable instruments, which are discussed below.

There is no concept of 'temporary equity' under IFRS. Many instruments that are classified as a financial liability under IFRS could be classified as equity or temporary equity under US GAAP, and certain instruments that are equity under IFRS could be classified outside equity under US GAAP. For further discussion on the differences between IFRS and US GAAP, see KPMG's publication, IFRS compared to US GAAP.

### Preference shares

The proper classification of preference shares depends on their respective terms and conditions. For example, preference shares that provide for redemption at the option of the holder give rise to a contractual obligation and therefore are classified as financial liability.

If dividend rights attached to the preference share are discretionary, the preference share is classified as equity. If they are not, then the preference share or a portion of it is classified as a financial liability. A preference dividend in which the contractual dividend payment is contingent on the availability of future distributable profits differs from a discretionary dividend. With a discretionary dividend, the issuer is able to avoid the payment of dividends indefinitely.

However, the payment of a contingent dividend cannot be avoided indefinitely. Consequently, contingent dividends are classified as a financial liability.

### Puttable financial instruments and limited-life entities

Particularly in the case of limited-life entities (e.g. many investment funds and non-revolving securitization vehicles), care is required in evaluating the liability/equity classification criteria before concluding that financial instruments that are in the form of equity qualify for equity classification under IFRS.

The basic principle is that puttable financial instruments and limited-life entities are classified as financial liabilities. However, IFRS also has an exception for the classification of puttable instruments and obligations arising on liquidation. Certain puttable instruments and instruments that impose on the entity an obligation to deliver to the holder a pro rata share of the entity's net assets only on liquidation are classified as equity if certain conditions are met. However, for many limited-life entities, the instruments fail these conditions because there is a form of subordination as a consequence of the distribution waterfall; as a result, the financial instruments issued by these entities generally do not qualify for equity classification under IFRS.

### IASB's Financial Instruments with Characteristics of Equity (FICE) project

Applying IAS 32 to types of instruments not directly addressed by the requirements is difficult – e.g. some instruments contingently convertible to ordinary shares. Continuing discomfort over classification outcomes also raises concerns. The IASB therefore started its FICE research project in 2014.

As part of this project, the IASB plans to reinforce the underlying rationale of classification between liabilities and equity. It will provide clarification of liability/equity distinction under IAS 32, in particular for derivatives on own equity. The Board does not expect a significant change to classification outcomes compared with the current IAS 32 application. A FICE discussion paper is expected toward the end of 2017.

Meanwhile, the FASB will conduct additional research to decide whether it should add the topic of distinguishing liabilities from equity to its agenda, and if so, whether it should consider just specific issues and features or carry out a comprehensive reconsideration of the existing guidance. However, the outcome of the Boards' respective projects is unlikely to result in any significant degree of convergence.

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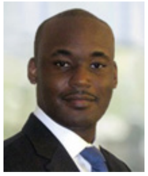

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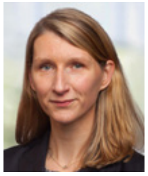

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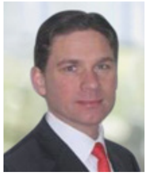

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