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IFRS News

Shedding light on the IASB's activities*

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Interview with IASB's Alan Teixeira on BC2

Issue of the month

Business Combinations phase 2: update direct from the IASB

Business combinations phase 2 ('BC2') has proved to be one of the IASB's more controversial projects. This month *IFRS News* has published a supplement devoted to a long interview with Alan Teixera, the IASB senior project manager on BC2.

BC2 is a significant project. The IASB and FASB aim to produce a joint standard – a single business combinations standard that will be a key milestone on the two Boards' convergence roadmap. Constituents expect the new standards to demonstrate that the IASB has addressed the significant concerns expressed by respondents to the exposure draft. The Board has already confirmed the fundamental principles of BC2 as part of the redeliberation process. However, Mr Teixeira explains in his interview that the principles were confirmed as a basis for discussion. Board deliberations will now focus on the outcomes of those principles and what exceptions are appropriate. So, it's all still 'in play' until the Board members have to vote on a final standard.

A new standard is some way off (the latest date is publication in the second half of 2007 with adoption in 2009), but interested parties are keeping an eye on developments. Many difficult areas are still under discussion.

Test your understanding

Do you know the hierarchy of the IASB's terms of likelihood? Consider the sample below, presented in a random order, and put them in order of probability. Check your answers against the correct order in the table on page 3.

- **Extremely rare**
- **Significant**
- **Reasonably certain**
- **Highly probable**
- **Minimal probability**
- **Possible**
- **Remote**
- **Virtually certain**

New Zealand's adoption of IFRS

Steve Todd leads PwC's Global ACS group in New Zealand and is a member of the New Zealand national standard setter. He talks to *IFRS News* about local adoption of IFRS and the challenges this presents.

New Zealand is adopting IFRS over a two-year transition period. Why has it chosen to do this rather than the one-off 'big bang' approach adopted in Europe and elsewhere?

The decision to adopt IFRS was only made in New Zealand in December 2004 following an earlier decision to adopt in Australia. The standard setters decided at that time that it would be unduly onerous to require adoption before 1 January 2007. They therefore set that as the mandatory adoption date. However, they were also conscious that the European and Australian parents of New Zealand subsidiaries would adopt IFRS from 1 January 2005, so they allowed any entity to adopt for any period after that date.

In practice this has worked out reasonably well, as it has allowed the work to be spread out over a much longer period rather than being compressed into a large one-off peak.

Which entities will be required to comply with IFRS?

That's a more complicated question than it looks. The standards that will apply are in fact 'New Zealand equivalents to IFRS' (NZ IFRS). These standards apply to all entities, large and small, in all sectors (for profit, not for profit and public sector). NZ IFRS is word-for-word identical to the original standards but with some minor adjustments.

For large, profit-oriented entities, the adjustments are restricted to making additional disclosures or removing one of the allowed options under the original standards; for example, under NZ IAS 7, the cash flow statement must be prepared using the direct method. Large, profit-oriented entities will therefore comply with both NZ IFRS and IFRS simultaneously.

The adjustments for not-for-profit entities and service-oriented public sector entities ('public benefit entities') are more substantial. In some instances, IFRSs simply do not work. An example is impairment for assets whose value is not recovered through the generation of cash flows. For these assets, NZ IAS 36 has a different impairment test to be applied by public benefit entities. This means that although public benefits entities comply with NZ IFRS, they are unable to claim compliance with IFRS.

Lastly, we have for many years operated a Framework for Differential Reporting (a New Zealand version of SME standards) for small and certain other entities that are not publicly accountable. Under the Framework, qualifying entities are exempted from making certain disclosures and, in a very limited number of cases, are permitted to measure items differently from the requirements of IFRS. Again, although this means that qualifying entities that apply exemptions comply with NZ IFRS, they are not able to claim compliance with IFRS.

How different is IFRS from the previous NZ GAAP? Have there been any major surprises?

The national standard setter has been working for many years to converge New Zealand standards with IFRS. The general approach is therefore not greatly different. However, IFRS has a number of standards for which there was no existing New Zealand equivalent. Principal among these are recognition and measurement of financial instruments, intangible assets, revenue and employee benefits. It is therefore no surprise that these areas are where the majority of the reconciling items in the opening balance sheets arise.

With respect to major surprises, I would say the biggest is the realisation of how much history matters.

What do you mean by 'history matters'?

Under the old regime, we set our own standards and there was little variation in how these were interpreted. New Zealand is such a small market that people know and talk to each other, and we usually reach a common understanding of the intent of a standard.

With IFRS, all that has changed. Suddenly the words of a standard are being read and interpreted by a huge number of people from enormously varied backgrounds. Each individual's interpretation of a standard will inevitably be coloured by their background and training, and it is surprising how often someone else will come up with a view that you have never considered before. Here is a simple example: under the old New Zealand consolidation standard, entities subject to de facto control were always consolidated. It therefore came as something of a surprise to us that others were adamant that you could not consolidate an entity on the basis of de facto control. Reading IAS 27 with this new perspective in mind, it is quite easy to understand this alternative view.

In the short term it can be frustrating to have these varied viewpoints, but in the long run I have no doubt that the process of standard setting, the resulting standards and the interpretation of those standards will benefit enormously.

How do you think New Zealand is coping with adoption of IFRS?

Overall I think we are coping well. The two-year transition period is proving to be particularly helpful: a relatively small number of entities adopted early, so we will be able to apply the lessons learnt from the experience of those entities to later adopters. We are also able to leverage and learn from the experience of others around the world who had to adopt in 2005. I think there is also a general acceptance in New Zealand that the adoption of IFRS was both inevitable and will, in the long run, be beneficial.

Reducing probabilities? First step to common accounting language

PwC partner in the Netherlands Simon Wray looks at the IASB's use of language and the difficulty in interpreting some of the subtleties of IFRS terminology.

English is widely used around the business world. Accountants involved in financial reporting, however, are becoming increasingly aware of the challenges posed by the use of terms written in English but understood differently depending on the culture and knowledge of those working in the profession.

You might, for example, expect that the term 'probable' would give rise to a common understanding between the Americans and the English, even if a shared understanding might be harder to achieve amongst those for whom English is their second or third language. Unfortunately, even that expectation does not hold water. Probable, to many English accountants, means more likely than not – say, a probability of 51% or more; to many American accountants, probable has a significantly higher threshold – in the region of perhaps 75%. This definition alone became so significant that the IASB predecessor body, the IASC, felt it necessary to explain in IAS 37 (provisions) that it was using 'probable' in that standard to mean 'more likely than not'. The IASB recently found it necessary to explain in IAS 39 (financial instruments) that the term 'highly probable' should be read as equivalent to the FASB's use of 'likely to occur'.

Potential for misunderstanding

A review of the full IFRS text suggests that the potential for misunderstanding the literature in relation to terms of probability is high. As the table below demonstrates, in addition to 'probable' and 'highly probable', there are 25 other terms embedded in the IFRS literature that require preparers and auditors to exercise their judgment at different levels of probability. Differing interpretation of terms is also a potential threat to convergence with US GAAP. The short-term convergence efforts have already shown that full convergence requires the same scope, the same words and the same meaning being attached to those words. Any other approach could lead to GAAP differences, intended or otherwise.

Translation factor

As accountants, we are not scared to exercise our judgment in the right circumstances, but first we need a shared picture of what a threshold condition really means. Add into the mix the fact that IFRS is now being translated into over 20 different languages, many of which have been embedded into national or regional laws, and the scale of the potential problem for diversity in understanding how to apply IFRS standards becomes transparent.

Take my home territory – the Netherlands. The Dutch are admired for their outstanding language skills. Despite this, the Dutch IFRS user group has been severely challenged by the complexity of

Terms of likelihood

How successful were you in re-ordering the terms of likelihood provided on p1? This is their correct order.

1	'Virtually certain'	IAS 37.33
2	'No realistic alternative'	IAS 37.10
3	'Highly probable' – significantly more likely than probable	IFRS 5 BC82
4	'Reasonably certain'	IAS 17.4
5	'Substantially all' (risks and rewards, recover, difference)	IAS 17.8
6	'Substantially enacted'	IAS 12.46
7	'Highly effective'	IAS 39.88
8	'Principally'	IFRS 5.6
9	'Significant'	IAS 18.14(a)
10	'Major part'	IAS 17.10(c)
11	'Probable' – more likely than not'	IAS 37.14(b)
12	'More likely'	IAS 39.22
14	'Likely'	IAS 39 AG 40
15	'May, but probably will not'	IAS 37 Appdx A
16	'Reasonably possible'	IAS 32.92
17	'Possible'	IAS 37.10
18	'Unlikely'	IAS 39 AG44
19	'Highly unlikely'	IAS 40.31
20	'Extremely unlikely'	IFRS 4 Appdx B23
21	'Minimal probability'	IFRS 4 Appdx B25
22	'Sufficiently lower'	IAS 17.10(b)
23	'Insignificant'	IAS 39.9
24	'Remote'	IAS 37.28
25	'Extremely rare'	IAS 1.17
26	'Virtually none'	IAS 34.IN6
27	'Not genuine' (highly abnormal and extremely unlikely to occur)	IAS 32.25

the IFRS literature. There is an understanding that modern-day accounting is inherently complicated, but it is less easy to accept complexity that arises from the use of unduly difficult language when it could and should be avoided. This challenge is greater still in territories where the command of English among preparers and auditors is at a lower level. The level of complexity is a particular barrier to the wider adoption of IFRS among the small and medium-sized businesses that form the backbone of the Dutch economy.

We need to remind ourselves of the background to IFRS, which sheds a lot of light on how this situation has arisen. Many of the IFRS standards were developed by individual national standard setters using the language of that country. IAS 32 (debt equity) is substantially the standard developed by the Canadian standards board; IAS 39 (financial instruments) is substantially based on its US GAAP equivalent; and IAS 37 (provisions) is substantially based on work done by the UK standard setter. It should be no surprise – given that the IASC itself had few own resources and was dependent upon work subcontracted to others – that a higher than desirable level of diversity was the result. So how has the IASB performed, when compared to the IASC? 'Needs to do better' seems to be the response, based upon the experience of IFRSs 1 to 7. IFRS 4, Insurance Contracts, and IFRS 5, Non-current Assets Held for Sale and Discontinued Operations, added to the list of threshold measures, with the prize going to IFRS 4 for the addition of 'extremely unlikely' and 'minimal probability'.

Time to reflect

There is a good case for the IASB to pause for a minute and look closely at how it guides its staff in the use of different probability thresholds and in the construction of plain English text more generally. For example, a comprehensive authoritative glossary would help the staff and constituents, and a strategy to reduce the number of probability thresholds to, say, a maximum of between five and 10 would be a notable success.

IFRS diary

Looking forward

22 June 2006 – IASB publishes exposure draft of 'Proposed Amendments to IAS 32, Financial Instruments: Presentation'; and 'IAS 1, Presentation of Financial Statements: Financial Instruments Puttable at Fair Value and Obligations Arising on Liquidation'. Comment deadline **23 October 2006.**

6 July 2006 – IASB and FASB publish discussion paper on joint conceptual framework. Comment deadline **3 November 2006.**

20 July 2006 – IFRIC issues interpretation: IFRIC 10, Interim Financial Reporting and Impairment.

24 August 2006 – IFRIC issues interpretation: 'D19, IAS 19 – The Asset Ceiling: Availability of Economic Benefits and Minimum Funding Requirements'. Comment deadline **31 October 2006.**

29 September 2006 – comment deadline expires for exposure draft on 'Proposed Amendments to IAS 23, Borrowing Costs'.

Looking back

17 July 2006 – comment deadline expires for exposure draft 'Proposed Amendments to IAS 1, Presentation of Financial Statements'.

2 June 2006 – comment deadline expires for exposure draft on 'Proposed Amendments to IFRS 2 – Vesting Conditions and Cancellations'.

1 June 2006 – comment deadline expires for exposure draft on 'IFRIC D15, Reassessment of Embedded Derivatives'.

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