

IFRS news

IASB publishes hedging review draft

The IASB has issued a review draft (RD) that details the new hedge accounting requirements. Menno Ten Hacken looks at the implications.

In this issue:

- 1 **Hedging proposals**
- 2 **Joint venture or joint operation?**
Classification of joint arrangements
- 6 **IFRS quiz**
Operating segments
- 9 **Contacts**

The IASB has addressed several of the current concerns around hedge accounting rules in this third phase of its replacement of IAS 39 with IFRS 9. So what does the review draft propose?

Key provisions

Hedge effectiveness tests and eligibility for hedge accounting

It relaxes the requirements for hedge effectiveness assessment and consequently the eligibility for hedge accounting. The RD replaces the current requirements with a requirement for there to be an economic relationship between the hedged item and hedging instrument, and that the hedged ratio of the hedging relationship is the same as the quantity of the hedged item and hedging instrument that the entity actually uses for its risk management purposes.

Hedged items

The changes to the rules for determining what can be designated as a hedged item primarily remove restrictions that today prevent some economically rational hedging strategies from qualifying for hedge accounting. This is good news for entities that hedge non-financial items for a commodity price risk that is only a component of the overall price risk of the item, as it is likely to result in more hedges of such items qualifying for hedge accounting. In addition, the RD makes the hedging of groups of items more flexible, although it does not cover macro hedging

(this will be the subject of a separate due process document in the future).

Treasurers commonly group similar risk exposures and hedge only the net position (for example, the net of forecast purchases and sales in a foreign currency). Under IAS 39 today, such a net position cannot be designated as the hedged item. The RD permits this if it is consistent with an entity's risk management strategy. The board also decided to allow hedge accounting for equity instruments at fair value through other comprehensive income, even though there will be no impact on profit or loss from these investments under IFRS 9.

Hedging instruments

The RD relaxes the rules on using purchased options and non-derivative financial instruments as hedging instruments. The RD views a purchased option as similar to an insurance contract such that the initial time value (that is, the premium generally paid) will be recognised in profit or loss – either over the period of the hedge if the hedge is time related, or when the hedged transaction affects profit or loss if the hedge is transaction related. Any changes in the option's fair value associated with time value will be recognised in 'other comprehensive income' (OCI). The same accounting requirement may also be applied for the interest component of a forward contract. This should result in less volatility in profit or loss for these types of hedge.

Presentation and disclosure

The accounting mechanics and presentation requirements in IAS 39 remain largely unchanged in the RD. However, the RD requires all disclosures on the effects of hedge accounting to be disclosed in one comprehensive note in the financial statements.

Am I affected?

All entities that engage in risk management activities, regardless of whether they use hedge accounting today, will potentially be affected by the changes. As many of the changes remove restrictions, it may be beneficial for entities to revisit their risk management strategies that currently do not achieve hedge accounting to see if they will now be permitted. The new requirements are effective for accounting

periods beginning on or after 1 January 2015, with earlier application permitted only if the earlier completed phases of IFRS 9 are also adopted at the same time.

What do I need to do?

The board is not soliciting comments on the RD but has published the review draft to provide an extended 'fatal flaw review' period largely to ensure it is operational. The final standard is expected either late 2012 or early in the new year.

Given the potential impact on accounting and operations, management should assess the implications of new requirements on existing hedging strategies and consider commenting on the RD where it has concerns about how to apply it in practice.

Joint venture or joint operation?

There is only one question when it comes to accounting for joint arrangements: is it a joint venture or a joint operation? In this article, Akhil Kapadiya provides some guidance on how to make this assessment.



The classification of joint activities under IAS 31 seldom created any controversy or even much discussion. Unincorporated activities were either jointly controlled operations or jointly controlled assets with identical accounting. Anything in a legal entity was a 'jointly controlled entity', with management able to choose between proportionate consolidation and equity accounting. So there was rarely any pressure on the classification of the joint arrangement.

IFRS 11 has changed all that; the policy choice has been abolished, and accounting and presentation is driven by the classification of the joint arrangement. The decision on classification will be straightforward in most cases, but there will be instances where management will need to carry out significant analysis and exercise judgement.

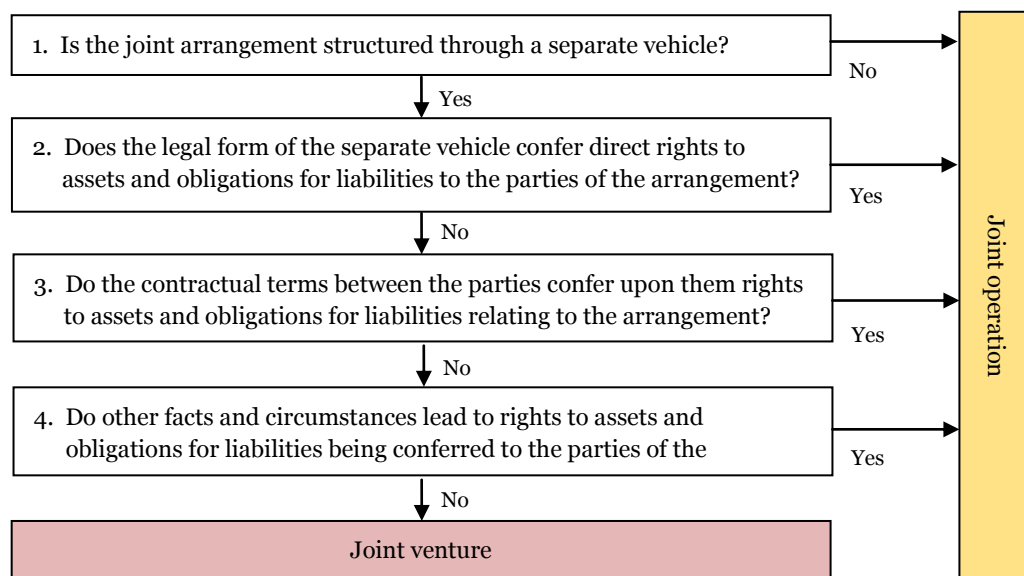
Classification under IFRS 11 is driven by the rights and obligation of the parties arising from the arrangement, rather than the legal form of the arrangement. There are now only two types of joint arrangement and two types of accounting: joint venture (equity accounting) and joint operations (direct accounting for assets and liabilities).

Most arrangements classified as jointly controlled operations and joint controlled assets under IAS 31 will be classified as joint operations under IFRS 11. The main change in classification arises in respect of joint arrangements conducted in legal entities. A joint arrangement undertaken in a legal entity that creates separation between the parties to the arrangement and the arrangement is most likely to be classified as a joint venture under IFRS 11, but this will not always be the case. There

will be some joint arrangements in legal entities that will be classified as joint operations because of the contractual arrangements between the parties or other relevant facts and circumstances.

A four-step process

Determining the classification of joint arrangements can be set out as a four-step process.



This article focuses on Steps 3 and 4.

Step 3 – Consider contractual arrangements

The rights and obligations agreed to by the parties in their contractual terms are normally consistent with those conferred on the parties by the legal form of the separate vehicle. However, the parties to the arrangement might choose a particular legal form that responds to, for example, tax or regulatory requirements and then enter into contractual arrangements that modify the legal form of the arrangement. If the contractual terms give the parties rights to assets and obligations for liabilities, the arrangement is a joint operation.

The assessment of rights and obligations should be carried out as they exist in the ‘normal course of business’ (IFRS 11.B14). Legal rights and obligations arising in circumstances which are other than in the

‘normal course of business’ such as liquidation and bankruptcy are much less relevant.

Guarantees issued by the parties

Parties to joint arrangements may provide guarantees to third parties on behalf of the arrangement.

The provision of guarantees or commitments is not conclusive for classification, although it may be indicative of the parties’ willingness to fund the obligations of the arrangement.

Step 4 – Consideration of ‘other facts and circumstances’

Assessing ‘other facts and circumstances’ includes considering the purpose and design of the arrangement, its relationship to the parties and its source of cash flows. An arrangement designed primarily for the provision of output to the parties may indicate that the objective of the parties

was to have direct access to the assets of the arrangement. The parties may well be obligated to purchase or take all of the output of the joint arrangement. The purchase and sale agreements, off-take arrangements or cash calls may indicate that the parties are the sole source of cash flows for the joint arrangement.

The effect of an arrangement with such a design is that the liabilities incurred by the arrangement are in substance satisfied by the cash flows received from the parties and is indicative of a joint operation.

Factors to consider when assessing 'other facts and circumstances'

Some or all of the following characteristics might indicate that a joint arrangement in a legal entity should be classified as a joint operation.

1. The joint arrangement may be prohibited from selling any of its output to third parties.
2. The parties will have uninterrupted access to the output.
3. There is likely to be a binding obligation on the parties to purchase substantially all of the output.

4. The demand, inventory and credit risks relating to the activities of the arrangement are passed on to the parties and do not rest with the arrangement.
5. The output or services are priced to cover the costs of the arrangement and not expected to generate significant net income.
6. The arrangement is unlikely to have any third-party borrowings without guarantees or take-or-pay arrangements with the parties.

Applying the classification criteria

The following assumptions are common to each of the scenarios considered below: (a) joint control exists; and (b) there is a legal entity that creates separation between the parties and the joint arrangement. The initial indicators are that the arrangements are joint ventures. How might 'other facts and circumstances' affect the classification of the arrangement?

Scenarios	Classification	Analysis
<p>The arrangement manufactures seats for cars. Both parties are in the business of assembly and sale of cars. Both are obligated to take output in proportion to their shareholding.</p> <p>The price of the seats is set by the parties at a level such that the arrangement operates at break-even.</p> <p>The arrangement is prohibited from selling the seats to third parties.</p>	Joint operation	<p>The design of the arrangement is to provide all its output to the parties. It is dependent on the parties for its cash flows to ensure continuity of operations. The parties get substantially all the economic benefits from the assets of the arrangement.</p>
<p>The joint arrangement produces a commodity such as oil, which is readily saleable in the market. The parties are obligated to buy their share of the output and if they do not take their share they can be cash called for a share of operating costs.</p>	Likely to be a joint operation	<p>The parties are obliged to take their share of the output or fund the operations of the joint activity. The fact that the product is readily saleable becomes less relevant because there is an obligation on the arrangement to sell all of its output to the parties.</p>

Scenarios	Classification	Analysis
<p>The arrangement produces dry gas and gasoline. 100% of the dry gas is taken by one party and 100% of the gasoline is taken by the other party. The joint arrangement may not make sales to other parties. Both products are priced at raw material cost plus a processing margin to cover the operating costs of the joint arrangement.</p> <p>Each party uses its respective product in their business. Any residual profit or loss in the arrangement is distributed by way of dividends to the parties in the proportion of their shareholding but is not significant.</p>	Likely to be a joint operation	<p>The parties may engage in the joint arrangement to obtain cost savings or to guarantee supplies. They do not have to share all the products in proportion to their shareholding.</p> <p>The arrangement is dependent on the parties for cash flows, and the parties take all the output. This is a strong indicator that the arrangement may be a joint operation.</p> <p>However, all relevant facts and circumstances should be considered and the economics of the arrangement fully understood before concluding.</p>
<p>Parties have a right of first refusal to buy the output from a joint arrangement but they are not obligated to take the output.</p> <p>The arrangement was established three years ago.</p> <p>Y1: the parties take all the output in the ratio of their shareholding.</p> <p>Y2: the product is sold to third parties.</p> <p>Y3: the parties take the output but in a ratio different from their shareholding.</p>	Likely to be a joint venture	<p>The following factors indicate that the arrangement is most likely a joint venture.</p> <ul style="list-style-type: none"> • There is no obligation on the arrangement to sell its output to the parties; • Output has been sold to third parties. <p>This proves that the arrangement is not substantially dependent on the parties for its cash flows.</p>
<p>Two parties set up an arrangement to manufacture a product. The product is sold to third parties. As per the contractual terms:</p> <p>(a) All the gross cash proceeds from revenue of the arrangement are transferred to the parties on a monthly basis in proportion of their shareholding;</p> <p>(b) The parties agree to reimburse the arrangement for all its costs in proportion of their shareholding based on cash calls.</p>	Likely to be a joint venture	<p>The purpose and design of the arrangement is not to provide all of its output to the parties.</p> <p>The arrangement is selling the product to third parties and generating its own cash flows.</p> <p>Transferring gross proceeds of revenues to the parties and making cash calls for incurring its costs does not indicate that the parties have rights to assets and obligations for liabilities of the arrangement. It is merely a funding mechanism. It is no different from the parties having an interest in the net results of the arrangement.</p>

Scenarios	Classification	Analysis
Two parties set up a joint arrangement. One of the parties takes 100% of the output at market prices; the other party only takes its share of the profits/loss made by the entity.	Judgement required	<p>All facts and circumstances have to be considered before determining the classification. Assessment of the economic rationale behind such arrangement might give an indication of the purpose and design of the arrangement.</p> <p>Assessment should be made whether one of the parties actually controls the arrangement or if there is an IFRIC 4 lease.</p> <p>The arrangement seems to have some features of a joint operation and some of a joint venture. The arrangement does not sell to third parties and is dependent on one of the parties for its continuous cash flows. However, one of the parties does not consume any of the output.</p>

IFRS quiz: operating segments



High-quality segment reporting will help a company comply with IFRS and support investor decision-making by providing a view of results through the eyes of management. How well can you spot a segment reporting issue? Try this month's quiz on IFRS 8, 'Operating segments', for a refresher on the common questions and hot topics. By David Bohl.

Q1: Which of the following is the core principle of IFRS 8?

- (a) An entity shall disclose information to enable users to evaluate the geographic areas in which it operates.
- (b) An entity shall disclose information to enable users to evaluate the nature and financial effects of the business activities in which it engages.
- (c) An entity shall disclose information that is reviewed by the board of directors.
- (d) An entity shall disclose information to enable users to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Q2: Which group or entity is not required by IFRS 8 to disclose segment information in its financial statements?

- (a) A group listed and traded on a small regional market.
- (b) A group containing a subsidiary whose equity is publicly traded. The group is not traded on any market and does not plan to file financial statements with any securities commission or other regulators.
- (c) An unlisted group in the process of preparing financial statements to be filed with a securities commission for the purpose of obtaining a publically traded equity.
- (d) A group with publically traded debt.

Q3: Entity A is a listed manufacturer with three business units: farming, construction and defence. There is a separate CFO for each of these three business units, who is responsible for operating, budgeting and reporting aspects of their respective business units. The CFOs report to the CEO, who evaluates the performance of each operational unit using a variety of management reports. The CEO is responsible for resource allocation decisions across the whole of Entity A. The CEO and the CFO of Construction Products are also members of the board directors together with three non-executive directors and the Group Chairman who oversees all corporate governance matters. The board of directors must approve any significant investment decided by the CEO. Who is the chief operating decision-maker (CODM) required to be identified by IFRS 8?

- (a) The Group Chairman.
- (b) The CFO of construction products together with the CEO.
- (c) The CEO.
- (d) The board of directors.

Q4: Entity B's CODM reviews monthly management reports with revenue-only information for Entity B's nine products sold. The report also has operating profit for three divisional branches that sell the nine products. Which of the following best describes Entity B's operating segments?

- (a) There are nine operating segments. The revenue information for the nine products indicates the CODM is assessing performance and allocating resources based on the product sales.
- (b) There are 12 operating segments because the CODM is reviewing both nine products and three divisional branches.
- (c) There are three operating segments. The review of revenue-only data is not sufficient for decision-making related to resource allocation or performance evaluation of a segment.

- (d) There are nine operating segments because individual products are always operating segments.

Q5: Does each operating segment have to be separately disclosed?

- (a) No, operating segments can be aggregated based on quantitative thresholds into the reported segments that are disclosed.
- (b) No, operating segments can be aggregated based on quantitative thresholds and qualitative characteristics into the reportable segments that are disclosed.
- (c) Yes, the operating segments information reviewed by the CODM must be disclosed.
- (d) Yes, the operating segments are a required disclosure, although the operating segments might be aggregated into reportable segments.

Q6: Entity C has mining operations in Canada and the Democratic Republic of the Congo. The CODM reviews operating profit for each of the countries, and each is an operating segment. Can the two operating segments be aggregated based on quantitative criteria?

- (a) Yes, the two operating segments meet the aggregation criteria because both are mining operations.
- (b) Yes, as long as the two operating segments have similar customers, products, production processes and distribution methods.
- (c) No, the individual countries need to have similar economic conditions, exchange control regulations and underlying currency for them to have similar economic characteristics.
- (d) No, operations in different countries cannot be aggregated.

Q7: Entity D's CODM reviews operating segment earnings before income tax (EBIT) to perform the CODM function. What metrics and information should be included in the segment disclosures?

- (a) EBIT, a clear explanation of how EBIT is defined and reconciliation to the IFRS numbers.
- (b) EBIT only.
- (c) Only IFRS-compliant numbers.
- (d) EBIT and reconciliation to the IFRS numbers.

Q8: Entity E has two reportable segments that generate material revenue from external customers and non-current assets in the US, Canada, Germany, France and the Netherlands. What geographic information should Entity E disclose?

- (a) Revenue from and non-current assets of each of those individual countries.
- (b) Revenue and non-current assets from each geographic area: North America and Europe.
- (c) Revenue from each of those individual countries.

- (d) Revenue from each geographic area: North America and Europe.

Q9: Entity F's CODM reviews operating profit information on both a product and geographical basis. There are business unit managers for each of the products but not the geographic regions. Should the reportable segments be based on product or geographic operating segments?

- (a) Both product and geographic segments.
- (b) Only geographic segments.
- (c) There is a policy choice.
- (d) Only product segments.

Q10: A change in the measure of segment performance reviewed by the CODM (for example, EBIT, EBITDA, etc) is required to be retrospectively presented. True or false?

- (a) True.
- (b) False.

Answers

Question 1: D – The core principle of IFRS is stated in IFRS 8.1.

Question 2: B – IFRS 8 applies to entities that prepare financial statements, and:

- whose equity or debt securities are traded in a public market; or
- that file, or are in the process of filing, financial statements with a securities commission or other regulatory organisation for the purposes of issuing any class of instruments in a public market.

The group will not be required to disclose segment information in choice B; however, the subsidiary would be required to (IFRS 8.2).

Question 3: C – The CEO is the CODM because he/she is responsible for resource allocation decisions and for evaluating segment performance (IFRS 8.7 -8.8). The board of directors is not the CODM because the presence of non-executive directors means the board is not actively involved in reviewing information of an operating nature to assess performance and allocate resource.

A CODM should be involved in discussing operating activities, financial results or other plans for the segment with the 'segment manager' or might also fulfil the role of segment manager.

Question 4: C – Revenue-only data is rarely useful for assessing performance and allocating resource, such as when costs are minimal. So the three operating segments is the best answer.

Question 5: B – Only the reportable segments are required to be disclosed. Operating segments can be aggregated based on qualitative criteria (IFRS 8.12) and quantitative thresholds (IFRS 8.13).

Question 6: C – Operating segments in different countries can be aggregated as long as the individual country segments have similar economic characteristics and are similar in each of the other areas set out in IFRS 8.12. Canada and the Democratic Republic of the Congo do not share similar economic conditions, exchange control regulations and underlying currency.

Answers (continued)

Question 7: A – IFRS 8.25 requires the information presented to be on the same basis as reported internally, even if the segment information does not comply with IFRS. IFRS 8.27 and 28 require a clear explanation of the reported measurement basis and a reconciliation to IFRS figures.

Question 8: A – An entity is required to report revenues attributed to its country of domicile and attributed to all foreign countries in total from which it derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues are disclosed separately [IFRS 8.33].

Question 9: D – Only ‘products’ has a segment manager; therefore, ‘products’ is the

set of components that constitutes the operating segments [IFRS 8.9].

Question 10: B – IFRS 8 only requires restatement when there has been a change in the composition of the segments resulting from changes in the structure of an entity’s internal organisation, unless impractical. It might be appropriate to show all segment information on a comparable basis if it is practicable. Note: IFRS 8 para 27(e) requires disclosure of “the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss” if prior years’ information is not restated.

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