

IFRS News

Shedding light on the IASB's activities*

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Issue of the month

Reassessment of embedded derivatives

The International Financial Reporting Interpretations Committee issued Draft Interpretation D15, *Reassessment of Embedded Derivatives*, earlier this year to provide guidance on the timing of the assessment for embedded derivatives. GCRG's Kevin Klein looks at the impact of the interpretation.

Background to D15

An embedded derivative is a derivative instrument that is combined with a non-derivative host contract to form a single hybrid instrument. Where an embedded derivative is deemed to be closely related to the host contract (ie, the embedded derivative does not change the nature of the contract's risks), separate recognition of the derivative instrument from the host contract is not required. IFRS does not provide extensive guidance on how or when to make the closely related judgement but provides examples of what is and is not closely related.

The assessment of whether a contract contains an embedded derivative depends on external circumstances that could change over time. The conclusion that an embedded derivative is closely related to the host contract could change as a result of a change in market circumstances if continuous reassessment was required under IAS 39.

The following examples are of two entities that adopted IAS 39 as of 1 January 2005:

- Entity A, an energy company based in the UK, entered into a 20-year contract with Entity B to supply gas in April 1991. The contract price was linked to a fuel oil index because there was no gas market in the UK at inception of the contract. A UK gas market developed in 1997.
- Entity C, which is based in Country X, entered into a 10-year fixed price purchase contract denominated in USD with Entity D in 2000. The USD is not the functional currency of Entity C or D. The USD is a commonly used currency in Country X under IAS 39: AG33(d)(iii) at the inception of the contract. Country X joined the EU in 2004. The USD is no longer commonly used in terms of IAS 39 from 31 December 2004.

Each example shows that management determined the embedded derivative (fuel oil index and USD) to be closely related to the host contract at the inception of the contract. A change in the local market meant that the facts and circumstances underlying the conclusion had changed prior to the adoption of IAS 39 on 1 January 2005. The accounting treatment depends on when an entity is required to assess whether an embedded derivative is closely related to the host contract: at inception of the contract versus at transition to IFRS. The latter would cause significant volatility in the entity's financial statements on adoption of IAS 39.

D15 and PwC's views

D15 requires an entity to assess whether an embedded derivative is

closely related when it first becomes party to a contract. D15 prohibits subsequent reassessment of embedded derivatives unless there is a change in the terms of the contract, in which case it is required.

D15 expressly recognises that the same principle applies to an entity that purchases a contract containing an embedded derivative. The date when it first becomes party to the contract is the date of purchase. The draft interpretation is unclear on whether this guidance also applies to contracts purchased as part of a business combination. The IFRIC considered this issue in February 2005 and noted that it raises questions beyond the scope of D15. The IFRIC decided to consider addressing it in a separate interpretation of IFRS 3.

The interpretation does not clearly explain what constitutes a change in the terms of a contract that requires a reassessment. A sensible benchmark for reassessment might be if an alteration in the terms of a contract changes the variability in cash flows under the contract. Reassessment should be prohibited if there is no such impact.

Conclusion

D15 provides critical guidance that eliminates what could have been a significant IAS 39 adoption issue for many entities. This interpretation provides clarification of the existing literature without contradiction, so entities should follow its principles in the preparation of their first IFRS financial statements.



IAS 19 amendments and interims

Many companies have considered the option of recognising actuarial gains and losses through the Statement of Recognised Gains and Losses (SoRIE). The impact on presentation of the movement in equity under IAS 1 was highlighted in the May issue of IFRS News. An aspect that is often overlooked, however, is the potential impact on interim reporting and the need to update actuarial valuations. GCRG's Richard Davis explains.

There are two aspects of IAS 34 that must be taken into account when looking at IAS 19. It is crucial to consider these when making a decision to use the IAS 19 option to recognise actuarial gains and losses immediately in the SoRIE.

IAS 34 B9 states: *'Pension cost for an interim period is calculated on a year-to-date basis by using the actuarially determined pension cost rate at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements, or other significant one-time events.'*

IAS 34.28 states: *'...the frequency of an entity's reporting (annual, half-yearly, or*

quarterly) shall not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis.'

Any curtailment, settlement, plan amendment or significant cash flow should be reflected, like impairments, in the period in which it occurs. However, it is unclear what 'significant market fluctuations' would need to be reflected. The corridor and spreading approach means actuarial gains and losses do not impact on the current reporting period expense. Any amortisation is only based on the position at the start of the year. Preparers have therefore only obtained an updated valuation in extreme circumstances.

These arguments cannot be justified where a company has elected to recognise gains and losses immediately in the SoRIE. It is likely that the actuarial gains and losses arising in an interim period would be material, even in relatively stable markets. All the actuarial gains and losses are recognised immediately, so the result for the full year would be the sum of the experience in the interim periods, even if gains in one period are cancelled out by losses in another.

Actuarial valuations should be updated for movements in the assets and liabilities when they are included in the SoRIE for interim periods.



Proposed amendments to IAS 37 and IAS 19 – clarification or wholesale change?



The IASB has issued an exposure draft of 'Proposed Amendments to IAS 37, Provisions, Contingent Liabilities and Contingent Assets, and IAS 19, Employee Benefits' for comment in conjunction with the exposure drafts on IFRS 3 and IAS 27. GCRG's Yap-Kim Bong and Richard Davis examine the key proposals.

There is considerable difference of opinion on what the proposals mean. Some have commented that the revisions are simply clarification of the existing standard and some additional anti-abuse measures against 'big bath' restructurings and unrealistic 'obligations'. Other observers are concerned at the disposal of the probability criterion and the recognition of contingent assets and liabilities. There is also concern about how these proposals will reconcile with other projects such as revenue recognition and Insurance phase 2. This article describes the proposals but does not comment on all potential consequences if they are implemented as drafted.

New title and scope

IAS 37 would be re-titled 'Non-financial liabilities'. Consistent with this new title, the scope of the standard would be extended to include all non-financial liabilities that are not within the scope of other standards. This proposed change would be effective in designating each liability to applicable standards. It is questionable, however, whether new IAS 37 would be adequate to deal with current 'homeless' non-financial liabilities such as deferred income.

The term 'provision' would no longer be defined, but entities could continue to use the term to describe some classes of non-financial liabilities in their financial statements.

Higher hurdle for constructive obligations?

An entity would now have a constructive obligation only if its actions have resulted

in other parties having a valid expectation on which they can reasonably rely on the entity to discharge its responsibilities. The following criteria must be met to demonstrate a constructive obligation in the absence of a legally enforceable contract:

- the entity has indicated to other parties that it will accept particular responsibilities;
- the other parties can reasonably expect the entity to perform those responsibilities; and
- the other parties will either benefit from the entity's performance or suffer harm from its non-performance.

The exposure draft predicts that fewer cases of constructive obligations would be recognised as non-financial liabilities as a result of the above clarification.

Bring contingencies onto balance sheet

The notion of contingent assets and liabilities would disappear. Assets and liabilities would be divided into unconditional rights and obligations; and conditional rights and obligations.

Unconditional rights and obligations (sometimes called 'stand-ready' obligations) would be recognised as assets and liabilities respectively if their amount can be reliably measured. Conditional rights and obligations would not.

Many items previously described as contingent assets and contingent

liabilities are expected to be recognised as assets and liabilities under the new guidance. This is because the contingent assets and liabilities usually have elements of unconditional rights or obligations on which assets and liabilities should be recognised. The conditional rights or obligations relating to the contingencies would, however, affect the measurement, and therefore the amount recognised may turn out to be small. Measurement issues could also arise on litigation contingencies, which would now be brought onto the balance sheet.

Remove probability criterion from liability recognition rules

The following liability recognition criterion is considered redundant as a result of the concepts of conditional and unconditional obligations and would be removed: 'It would be probable that an outflow of resource embodying economic benefits will be required to settle the obligation'.

Unconditional obligations to be recognised as a liability would always satisfy the probability criterion. The entity has a 'stand ready' obligation to perform, so there is little or no uncertainty that settlement will require some outflow of resources, which could be cash payments or provision of services. There may be uncertainty about the amount and timing of the resources that will be required to settle a liability, but these should be considered for the measurement rather than the recognition of the liability. Items that satisfy the definition of a liability in the Framework would be recognised unless they cannot be measured reliably. This may, however, conflict with the actual business

practices, which do not distinguish between conditional and unconditional obligations.

Measurement

Management would continue to measure a non-financial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date.

The amount that an entity would rationally pay should reflect all risks and uncertainties surrounding the obligation, under the current IAS 37, and the expected value approach is considered an appropriate basis. The exposure draft puts a greater emphasis on the measurement of a single obligation, as the most likely outcome may not be appropriate. For example, if an entity has a 10% chance of paying £1m and a 90% chance of not paying anything, the amount that an entity would rationally pay should be £100K (using the expected value approach). The current approach of measuring the obligation at the most likely outcome of zero would not be appropriate. This change would align the measurement requirements in IAS 37 with the requirements applied when ascertaining the fair value of liabilities and contingent liabilities assumed on acquisition.

Streamlined requirements for restructuring costs

The current IAS 37 guidance on provisions for restructuring costs would

be withdrawn. The existence and announcement of a restructuring are not sufficient to create a constructive obligation (as above). The costs associated with a restructuring would be recognised as a liability on the same basis as if that cost arose independently of a restructuring, as follows:

- the cost of employee termination benefits should be recognised in accordance with IAS 19;
- the cost of terminating a contract before the end of its term should be recognised in accordance with the requirements for onerous contract; and
- the cost that will continue to be incurred under a contract for its remaining term without economic benefit to the entity should be recognised in accordance with the requirements for onerous contracts.

Termination benefits

The treatment of termination benefits would be revised to draw a distinction between a ‘pure’ termination benefit and a ‘stay bonus’. A ‘pure’ termination benefit is a one-time compensation that is paid to employees who are not required to render future service to receive the benefits or who will not be retained beyond the minimum retention period. A ‘stay bonus’ is an additional benefit provided to employees who remain in service for a specified period

longer than the minimum retention period.

The benefits would be recognised initially as shown in the table below. Following the initial recognition, any remeasurement of termination benefits should be accounted for in accordance with IAS 19 as post-employment benefits.

Onerous contracts

Additional guidance would be provided for onerous contracts: if a contract becomes onerous as a result of the entity’s own actions, the resulting liability for that contract should not be recognised until that action has occurred. Where the onerous contract is an operating lease, the unavoidable costs of meeting the obligation should be based on the unavoidable lease commitment less any sublease rentals that the entity could reasonably obtain for the property. This is regardless of whether there is an intention to sublease the property or not.

Conclusion

Many view these proposals simply as clarifications of the existing requirements. Others see the proposed changes as provocative and predict unexpected consequences. Comments are due by 28 October 2005. All concerned parties should consider these proposals carefully and feedback via the available channels to the IASB.

	Voluntary	Involuntary
‘Pure’ termination benefit	Recognised in full when the employees accept the entity’s offer of voluntary redundancy. This is in contrast to the current IAS 37 treatment, where an estimated amount is recognised when the entity has a formal plan that it has communicated to affected employees.	Recognised in full when the entity has a formal termination plan that it has communicated to the affected employees.
‘Stay bonus’	Not applicable	Recognised over the period of future service, which commences when the plan is communicated.



Becoming an IFRS specialist

Dusty Stallings, from the US Florham Park office, is six months into her two-year secondment to PwC's Global Corporate Reporting Group in London. She talks to IFRS News about her role in the Group and how it has developed her IFRS knowledge.

What did you work on before your secondment?

I spent the last four years in the International Corporate Reporting Group, which is part of the US national office [Florham Park, New Jersey], where I focused on foreign private issuers and reconciliations to US GAAP. So it's a lot like the technical role I'm doing now in GCRG. Before that, I was in the audit practice working with real estate clients.

What are your role and objectives in GCRG?

I spend a lot of time on consultations. My specialist area is revenue recognition so there's always plenty of work! I'm currently writing a revenue publication as well.

Most of my time is spent on a mix of companies. At ICRG I had to be a generalist, as there were only a few of us, but I'm growing more industry expertise here. I have a strong SEC background so that's probably my main contribution to the Group.

My aim is to develop a knowledge of IFRS that is as natural to me as US GAAP. When someone asks me a question about US GAAP, I either know the answer or know where to look for the answer. I want that same level of comfort with IFRS.

The SEC will be developing its expertise in IFRS in order to review the accounts of foreign private issuers (FPIs) that are moving to US GAAP. FPIs need to be aware of what the SEC will be focusing on its accounts reviews, The SEC's comment letters on these

financial statements will be published on EDGAR, so companies will be able to look at what their competitors have been pulled up on and understand what the SEC is particularly interested in, what reconciliation items they consider acceptable. I am therefore here to develop my expertise in IFRS to be able to advise companies on these issues.

How did your secondment expectations match up with the reality?

It was pretty much what I expected in terms of work. I knew that the Group contained the firm's IFRS specialists and that it provided the best IFRS training – head and shoulders above other training events I had attended.

There's a different technical structure here: in the US national office, technical experts tend to be separate from the reviewers; here we really mix that up. I'm a revenue recognition expert but I review financial statements for many companies too.

What I didn't expect was the camaraderie and the high morale. There's a great appreciation for work/life balance here too. I knew that the group was culturally diverse, but I didn't realise how much I'd learn from that. You begin to see things a little differently and, from an accounting point of view, it has helped to hear the various perspectives.

Would you recommend doing a technical secondment to others?

I'm a firm believer that everyone should have to do a technical office secondment. It's getting more and more difficult to take

the time to research issues, so doing a technical rotation makes you take your client service hat off and put your risk management hat on. It gives you a better balance between the two.

I'd recommend to anyone who wants to do a technical rotation to come to GCRG because you're not going to get this experience anywhere else. You're not going to find many technical offices that have the mix of cultures that you find here.

How has your family adjusted to life in London?

They're enjoying it. My husband likes it here, which is amazing as he can always find something to complain about! My son is only six so as long as he has friends and a ball, he's happy.

It's been an incredibly smooth process. It was a little bumpy when we first got here but then we got settled. There is so much to offer in this region because you get your quiet, peaceful space and the bustling city. I thought I wouldn't like walking so much but it's part of the enjoyment of being here: taking in the culture as you walk.

Where do you see your career going in the future?

I'll be going back to Florham Park when I've finished here. I've made a point of staying in touch and keeping up-to-date with the issues that have arisen there so when I go back I won't be out of touch.

I hope the rest of my career is with PwC because I love working here. I see myself spending the next few years in a technical role when I go back to the US. Where that leads after that, who knows?



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