

IFRS News

Emerging issues and practical guidance*

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IASB publishes first of the financial instruments exposure drafts (ED)

The IASB issued the ED, Financial Instruments: Classification and Measurement, in July as phase 1 of its accelerated project to replace IAS 39 in accounting for financial instruments. The ED forms part of the IASB's response to the global financial crisis and is consistent with the recommendations made by the G20. Jessica Taurae in the Global Accounting Consulting Services central team looks at the details.

IAS 39 has been criticized for being difficult to apply and interpret and for exacerbating the current economic crisis. The G20, Financial Stability Board, Financial Crisis Advisory Group and others have urged the IASB to develop a comprehensive standard that will address key issues arising from the financial crisis.

This ED is the first of three that will replace IAS 39. The second ED will address impairment methodology (expected in October 2009). The third will address how to improve and simplify hedge accounting (expected in December 2009). The complete package, with the derecognition ED, will replace IAS 39 in 2010. The ED proposes to reduce the many financial instrument classification and measurement categories and their associated impairment models in IAS 39 to two.

The proposals

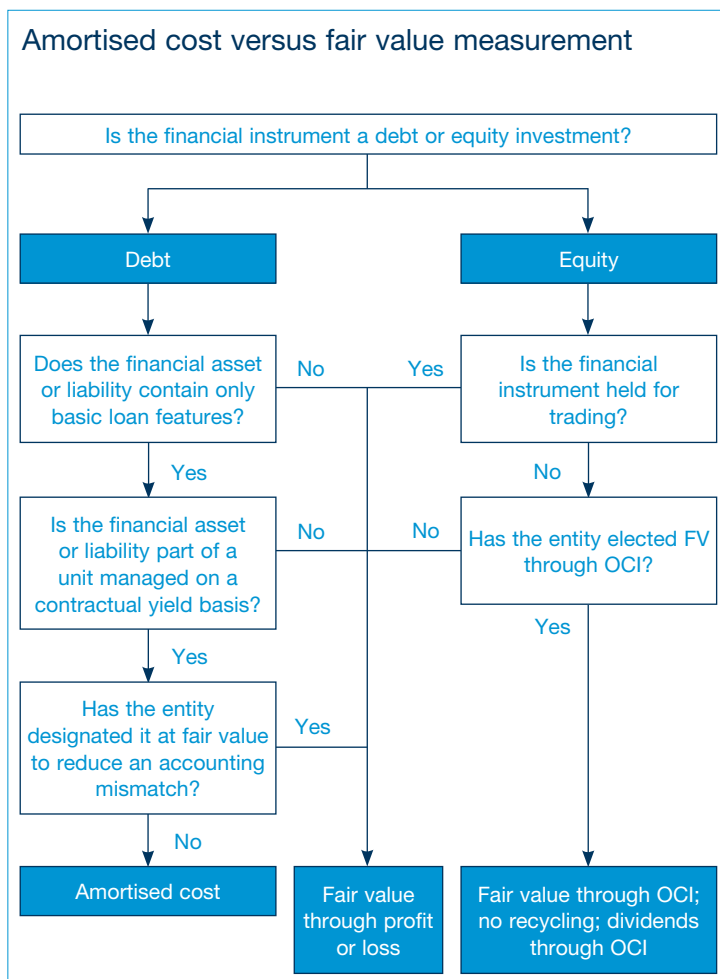
The ED proposes two measurement categories: amortized cost and fair value (see flowchart on page 2). Debt or equity classification is the first question management will need to consider.

Debt instruments

If a financial instrument is debt, companies will need to consider whether the financial asset or liability has basic loan features and is managed on a contractual yield basis (see box on p. 3). If yes, the financial instrument is eligible for amortized cost measurement. Companies will have the ability to designate that financial instrument at fair value through profit or loss if it reduces or eliminates an accounting mismatch. If the debt instrument does not have basic loan features or is not managed on a contractual yield basis, the instrument is measured at fair value through profit or loss. The proposals remove the held-to-maturity category and its tainting rules. Reclassifications between amortized cost and fair value are prohibited.

Equity instruments

Investments in equity instruments are always measured at fair value. Equity instruments that are held-for-trading are required to be classified as fair value through profit or loss. For all other equities, management has the ability to make an irrevocable election to present



changes in fair value in OCI rather than profit or loss. This treatment would apply for all fair value changes as well as dividends. There would be no recycling of amounts from OCI to profit and loss; nor would there be any impairment requirements. The proposals also remove the exemption to measure unquoted equity investments at cost when fair value cannot be determined reliably.

Embedded derivatives

The proposals remove the requirement to consider whether a financial instrument contains non-closely related embedded derivatives that require separation. The classification approach proposed in the ED would assess whether the entire financial instrument contains only basic loan features, including its embedded derivatives. Not all closely related embedded derivatives under the existing IAS 39 requirements today would necessarily be considered a basic loan feature under the proposals. The accounting for embedded derivatives in non-financial host contracts remains unchanged at this time.

Transition and effective date

The IASB is proposing that these amendments be applied retrospectively, with some exceptions to provide relief. For example, if it is impracticable to retrospectively apply the effective interest method or impairment requirements, the fair value of the financial instrument at the date of initial application is deemed the amortized cost of the financial instrument for subsequent measurement.

The proposed changes, if approved by the IASB, may be voluntarily adopted by entities in their December 2009 financial statements. However, the changes are not expected to be mandatory until January 2012. If an entity adopts the proposal early, additional disclosures are required.

Possible implications

More financial instruments may be measured at fair value than currently, although that will largely depend on the financial instruments the entity holds or issues. Many government bonds and plain vanilla corporate bonds would be considered to have basic loan features.

Below are some examples of how the proposed requirements might be applied.

What are non basic loan features?

- All asset-backed securities that are not the most senior tranche of the structure will be required to be measured at fair value through profit or loss, as they are seen as providing credit protection to other tranches and, therefore, do not have basic loan features.
- All synthetic collateralized debt obligations will be required to be measured at fair value through profit or loss, as they contain contractual terms that change the timing or amount of payments of principal or interest and do not protect the investor, but rather provide more risk to the investor.
- Most corporate-issued debt where an embedded derivative is currently separated and fair valued (including convertible bonds) will need to be measured in its entirety at fair value through profit or loss, including changes in own credit risk, as the embedded derivative would not be considered a basic loan feature.
- All financial assets that are acquired at a discount that reflects incurred credit losses do not have basic loan features according to the proposals in the ED. So, when financial institutions have acquired such loans from other financial institutions, the proposals would require those loans to be measured at fair value through profit or loss.

Managed on a contractual yield basis?

It is not clear whether financial instruments that are part of a liquidity portfolio will be required to be measured at fair value through profit or loss under the proposals. For example, an entity may hold a financial instrument to realize contractual interest and principal payments until the entity needs to fulfil an obligation, at which time it will sell the asset (for example, assets held by insurance companies). The possibility that the entity may need to sell the asset may imply that it is not managed on a contractual yield basis.

Next steps and coordination with FASB

Comments are due at the IASB by September 14, 2009. The IASB and FASB are committed to working together to develop a comprehensive standard to improve the reporting of financial instruments. The FASB is still developing its proposals and expects to issue an ED within the next few months. The IASB will expose for comment the FASB's proposals if they are materially different from the IASB's proposals. It is expected that the Boards will deliberate the responses to their respective ED jointly.

Significant changes are being proposed. Companies are encouraged to become engaged with this ED and constructively respond to the IASB's proposals.

Financial Instruments: Classification and Measurement ED at a glance

- The ED proposes two measurement categories: amortized cost and fair value.
- For debt instruments, only those financial assets and liabilities that have basic loan features and are managed on a contractual yield basis are eligible for amortized cost. A fair value option for reducing an accounting mismatch is also retained.
- All other debt instruments are to be measured at fair value through profit or loss.
- All equity investments are to be measured at fair value through profit or loss unless, at initial recognition, the entity elected to present changes in fair value through OCI and they are not held-for-trading.
- The ED removes the requirement to assess a financial instrument for embedded derivatives.
- The ED removes the exemption to hold unquoted equity investments at cost.
- Comments are due by September 14, 2009.
- Fixed return over the life of the financial instrument
- Variable return equal to a single quoted or observable interest rate (such as LIBOR)
- Combination of fixed and variable return (such as LIBOR + 50 basis points)
- Embedded caps, floors and collars
- Prepayment options where the prepayment amount substantially represents unpaid amounts of principal and interest

Managed on a contractual yield basis

Financial instruments are managed on a contractual yield basis only if they are managed and their performance is evaluated by the entity's key management personnel on the basis of the contractual cash flows that are generated when held or issued. The ED provides the following examples of managed on a contractual yield basis:

- Trade accounts receivable (or payable) that an entity holds to collect (or pay) the cash amounts due
- Financial instruments that an entity manages on the basis of contractual payments of principal and interest
- Issued bonds that the entity manages on the basis of contractual interest and principal that it pays to investors under the terms of the contract

Basic loan features

Basic loan features are defined as contractual terms that give rise, on specified dates, to cash flows that are payments of principal and interest on the principal outstanding. The ED provides some examples of basic loan features:

IFRS in brief – twice-monthly overview of IFRS hot issues in practice

Want a snapshot view of the latest IFRS developments? Keep up to date with IFRS hot issues by subscribing to *IFRS in brief*. This twice-monthly financial reporting newsletter provides high-level guidance on current accounting issues that may have a significant impact on your balance sheet, disclosure obligations and/or communication with stakeholders. *IFRS in brief* covers two topics in every issue, with each topic getting a page of coverage. It brings you the global insight and experience of PricewaterhouseCoopers' IFRS specialists and answers the questions: What is the issue? Am I affected? What do I need to do?

To view the latest edition of *IFRS in brief* please visit www.pwc.com/gx/en/ifrs-reporting/ifrs-inbrief.jhtml. To receive *IFRS in brief* by email twice a month email ifrs.communications@au.pwc.com.

Cannon Street Press

European Union (EU) endorsement

The EU endorsed the following standards in June:

- IFRS 3 (revised), Business Combinations, and the amendments to IAS 27, Consolidated and Separate Financial Statements. Both have an effective date for annual periods beginning on or after July 1, 2009; earlier adoption is permitted.
- IFRIC 16, Hedges of a Net Investment in a Foreign Operation. It is applicable for accounting periods beginning on or after October 1, 2008 and should be applied by EU entities for accounting periods beginning after June 30, 2009.

Final standard: IFRS for Small and Medium-sized Entities (SMEs)

The Board published the IFRS for SMEs in July. It is a self-contained standard of around 230 pages, tailored to the needs and capabilities of smaller businesses. Many of the principles of full IFRS for recognizing and measuring assets, liabilities, income and expenses have been simplified. The number of required disclosures has also been simplified and reduced. There is no requirement to refer to full IFRS if a topic is not covered in the IFRS for SMEs. The IFRS for SMEs will be updated approximately every three years and reissued as a complete volume.

The IASB estimates that SMEs, as defined in this standard, represent about 95% of companies worldwide. Immediate adoption is permitted, although it will be up to individual countries to permit, require or prohibit its adoption locally. PricewaterhouseCoopers is publishing the following materials on IFRS for SMEs:

- IFRS for SMEs: Pocket guide 2009. Now available on pwc.com/ifrs.
- Similarities and differences – a comparison of “full” IFRS and IFRS for SMEs. Available in late August.

- IFRS for SMEs – Illustrative financial statements 2009. Available in September.
- IFRS for SMEs – disclosure checklist 2009. Available in Q4.

Final standard: IFRS 2 amendments

The Board has published amendments to IFRS 2, Share-based payment – group cash-settled share-based payment transactions. The requirements will impact entities that receive goods or services in exchange for cash-settled share-based payments where the payments are made by another entity in the group.

These entities recognize in their separate financial statements an expense for those goods or services, regardless of which entity in the group settles the transaction or how the transaction is settled (that is, in shares or cash). The other side of the entry is an adjustment to equity, reflecting an equity contribution from the parent entity.

Subsidiaries that elect not to recognize an expense in their financial statements will need to change their accounting policy to reflect the amendments for annual reporting periods beginning on or after January 1, 2010. The new rules apply retrospectively, which means that affected entities will need to determine an adjustment to their opening retained earnings.

The amendment incorporates into IFRS 2 the guidance in IFRIC 8, Scope of IFRS 2, and IFRIC 11, IFRS 2 – Group and Treasury Share Transactions. IFRIC 8 and IFRIC 11 have, therefore, been withdrawn. The amended guidance in respect of group cash-settled share-based payment transactions will be effective for periods beginning on or after January 1, 2010.

Final standard: IFRS 1 amendments

The Board has issued amendments to IFRS 1, First-time Adoption of IFRS. These address the retrospective application of IFRS to particular situations and aim to ensure that entities applying IFRS do not face undue cost or effort in the transition process.

The amendments exempt entities using the full cost method from retrospective application of IFRS for oil and gas assets. They also exempt entities with existing leasing contracts from reassessing the classification of those contracts in accordance with IFRIC 4, Determining Whether an Arrangement Contains a Lease, when the application of local accounting requirements produce the same result. The amendments are effective for accounting periods beginning on or after January 1, 2010; earlier application is permitted.

Proposed changes to accounting for rate-regulated activities

The Board has published an ED relating to the accounting for rate-regulated activities. Rate regulation is usually imposed by regulatory bodies or governments to restrict the prices that can be charged to customers for services or products.

The proposals aim to establish how assets and liabilities resulting from rate-regulated activities should be recognized and measured under IFRS. There is currently no guidance in this area. If adopted, the IASB’s proposals will:

- Define regulatory assets and regulatory liabilities
- Set out criteria for their recognition
- Specify how they should be measured
- Require disclosures about their financial effects

The deadline for comments is November 20, 2009.

Discussion paper: Credit risk in liability measurement

The Board has published a discussion paper on the question of whether entities should factor in changes in their own credit risk to their liability measurements. The discussion paper was issued in response to concerns about recognizing gains resulting from reductions in the fair value of an entity's liabilities due to the impact of the entity's own credit risk (that is, the likelihood that the entity would default on payment of the liability).

It sets out reasons for and against, including credit risk in the fair value measurement of liabilities, and also provides some possible alternative accounting treatments.

The requirements will impact all entities that fair value their liabilities. For example, banks and other financial institutions commonly include their credit risk when remeasuring the fair value of certain liabilities. It will also impact entities that have derivatives in a liability position (for example, interest rate swaps).

The comment deadline is September 1, 2009.

Request for feedback: Feasibility of expected loss model for impairment testing

The Board has requested feedback by next month on the practical issues that might arise if an expected loss model for the impairment of financial assets was introduced.

The model would affect all entities with financial assets that are classified as held-to-maturity or loans and receivables. Entities with listed equity securities would not be affected; these financial assets would still need to be tested for impairment using market prices.

The current model, the incurred loss model, requires management to account for credit losses in financial assets only if events (such as financial difficulties of the borrower) have already occurred that have a negative effect on future cash flows. Management cannot consider the effects of future expected losses, no matter how likely they are to occur.

Possible or expected future trends that may lead to a loss in the future (such as an expectation that unemployment will rise or a recession will occur) are also not taken into account.

The expected loss model requires management to make an assessment of expected credit losses on initial recognition of an asset and for this to be continually assessed. There is earlier recognition of credit losses under this approach compared to the incurred loss model. Some observers believe this would better reflect the way that financial assets are priced and the way that some companies manage their business.

Proposed non-mandatory guidance: Management commentary

The Board has issued proposed non-mandatory guidance to help entities prepare and present a narrative report, often referred to as management commentary. This is the information that many entities choose to provide to users of their financial statements to show how their business's financial position, financial performance and cash flows relate to management's objectives and its strategies for achieving those objectives.

All entities that currently provide management commentary in their financial statements will be affected. Unlisted entities will be particularly affected because they do not currently have any guidance on what to include in their management commentaries.

The guidance will help entities prepare management commentaries that meet the needs of investors and other users of their financial statements. The Board also hopes the proposed non-mandatory guidance will improve the consistency and comparability of management commentary across entities around the world that apply IFRS.

The comment deadline is March 1, 2010.

How times have changed: financial reporting in the last 30 years



Global Accounting Consulting Services partner in the UK, Peter Holgate, takes a stroll down memory lane and looks at changes in financial reporting and the business environment over the last 30 years.

Young though I am,¹ I was indeed a member of the working population 30 years ago. At the time, I practised (literally) UK GAAP. I have the UK GAAP bound volume for 1977, in a charming shade of turquoise – a slim volume of some 263 pages that includes 11 accounting standards (SSAPs). I still refer to it occasionally. I think it still applies.

The UK GAAP book also included an ED (ED 18), which was the first proposal on current cost accounting. There was high inflation at the time, and it was thought that adjustments needed to be made to reflect the effect of specific price changes, mainly of what we now call PPE and inventory (no one thought much about fair value accounting for financial instruments). This ED became a standard in 1980 and was so unpopular that it led to a revolt by the members of the Institute of Chartered Accountants of England and Wales. These were exciting times. The standard had to be withdrawn, and the whole debacle was the beginning of the end of standard-setting by the professional bodies. In 1990, an independent standard setter (the UK ASB) was formed.

In the late 1970s, we had (just) heard of international accounting standards – the IASC had been formed in 1973 – but they were seen as something mainly for developing countries and nothing much to do with us. The capital markets focus that we now see was to emerge 10 or 20 years later. The IASC's board was made up entirely of part-time volunteer members with a secretariat of four – see box for more details. The IASC was still such a slim operation even some years later (1986) that, when I joined a predecessor firm after five years at the UK standard setter, I was given

a job of great responsibility by our deputy senior partner, who was a member of the IASC's board. The whole board and the whole secretariat were abroad for a week at a board meeting. It was my job to open up the IASC's offices every day, check the post and voicemail, and water the plants. The IASC's standard on agriculture followed a mere 15 years later.

The bound volume of IAS was also a slim book. I still have, and cherish as a historical document, the IASC's 1981 bound volume of IAS (it goes up to IAS 13, Presentation of Current Assets and Current Liabilities). It is 154 pages long. This includes the first (1979) version of IAS 12, which was the international standard on deferred tax, an answer that is probably no better or worse than the ones we are using and debating now. The difference is that it is only 14 pages long. My main observation is that, after 30 years' experience, we are able to write an equally unsatisfactory document with much greater length and obscurity.

The most notable difference from today was that you could do whatever seemed sensible. Standards were beginning to narrow down the options in accounting, but only in a limited way, and many choices remained. It is, of course, important to understand that this gave rise to the opportunity to exercise professional judgment; this is quite different from its being a free-for-all, in which anything goes. Professional judgment of the day included such skilled techniques as:

- Treating all leases as operating leases
- Ignoring share-based payments completely²

- Ignoring derivatives³
- Revaluing assets on a random basis
- Pretending that a 30-year-old tree was worth the same as a three-year-old tree
- Providing for a wide range of future expenses, especially future reorganization costs⁴

To be fair to the practitioners of the day, much of that seemingly lax regime can be explained by the fact that business was much simpler. Perhaps share-based payment awards were granted to employees but, if so, it was on a small scale. The whole area of derivatives was a tiny fraction of today's activity.

Also, the public interest was not so well developed. There was, therefore, little focus on management commentary and virtually no concept of environmental and social reporting. Similarly, there was a much less transparent (or less intrusive) regime relating to the disclosure of directors' emoluments and related parties generally (the IAS appeared in 1984). Analysts, for their part, were less organized, less vocal and less well served by accounting. The standard on segment reporting appeared in 1982, but more comprehensive information on, say, detailed analysis of debt, had to wait until IAS 32 was published in 1995.

Life, then, was simple. Unlike today, politicians were not involved in accounting. This is because, unlike today's more skilled politicians, they did not understand it. Aside from the auditors, there were no regulators to speak of, at least outside the US. It is surprising that we were able to stretch out our work to 5:30 p.m.

Peter Holgate
London, UK
(Aged 56¼, 49¾?)

1 Clearly an error in drafting the article, but not corrected through kindness - Ed.

2 Not that there were many, to be fair, except share-for-share acquisitions, which we did account for, though not very well

3 Not that there were many. At least, we didn't find many; and those that we found were generally not well understood.

4 Especially in profitable years

10 features of standard setting 30 years ago

1. No IASC framework
2. No SIC or IFRIC
3. A bound volume of standards that could fit any sized pocket
4. A bound volume of standards that could be afforded by any pocket
5. Chairman of IASC was not on the front page of the Financial Times every day
6. Board of IASC entirely part-time
7. Staff of four
8. Many options in standards
9. No illustrative examples, application guidance, implementation guidance or basis for conclusions
10. No listing of approving or dissenting board members

Response from the publisher



IFRS news publisher Mary Dolson¹ agrees with the author and his yearning for the charm of those simpler days, when the accounting standards would fit in her Diane von Furstenberg handbag. However, while 14 professional full-time paid standard setters and their small army of staff closely watched by the mighty of the business world have much to answer for in creating complexity of accounting standards, some of this complexity reflects the complex business environment that we all work in. Measuring

the obligation for final salary schemes may have led to their steep decline, but surely it's better for shareholders to know the extent of the company's obligations.

The five significant areas in which accounting has improved during my career are in the area of share-based payments, pensions, financial instruments, business combination accounting (banning poolings) and the requirement to present a cash flow statement. My personal opinion is that all of these resulted in significantly better information for users of financial statements.

¹ Mary refuses to disclose details about her age, although you can apparently find this on Facebook.

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