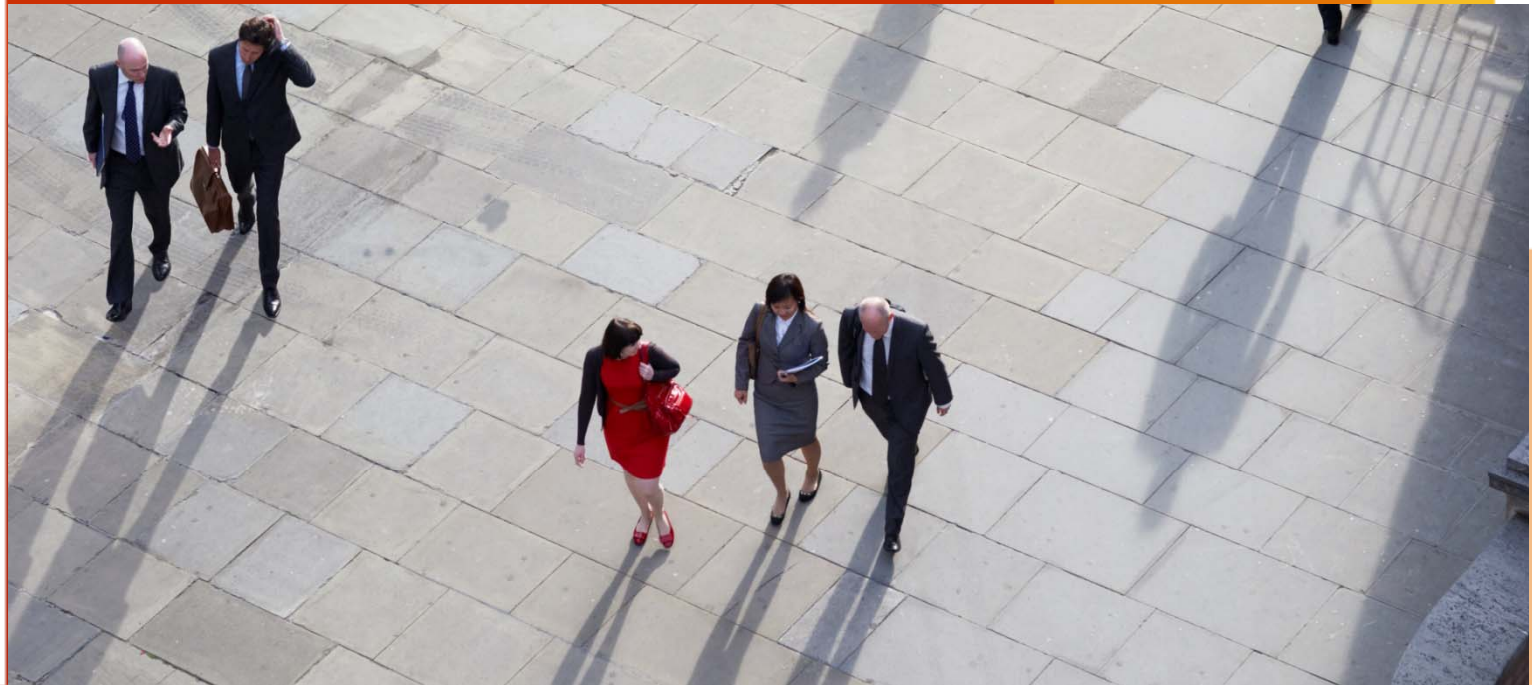


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***Boardroom Professional
Development
Audit Committee workshop –
Technical accounting update***

Non-
Executive
Director
workshop

January 2012



pwc

Agenda

1. Setting the scene
2. New for 2011 and recently issued standards
3. Significant IASB projects
4. The future of UK GAAP
5. FRRP activity and hot topics

Setting the scene

What's new
December

**...but watch out
for the FRRP, and
significant change
on the horizon!**

Not much...

How will future changes affect me?



Budgeting



Key metrics
(including
debt
covenants)



Controls
and
processes



Contract
negotiations

Setting the scene

1

IASB Update

The IASB after 10 years & its future work programme...

IASB in 2011

End of an era...



Sir David Tweedie retired from IASB June 2011, after 10 years



New chairman: Hans Hoogervorst



New vice-chairman: Ian Mackintosh

Features of the Tweedie era

- Better resourced IASB
- More complex standards
- Balance sheet model (assets and liabilities)
- Increased use of IFRS – most of world, excluding US – eg EU 2005
- Convergence programme with US
 - Norwalk agreement
 - Joint projects and board meetings
- Financial crisis – spotlight on FI accounting

Output of the Tweedie era

Finalised

- First-time adoption
- Share-based payment
- Business combinations
- Insurance contracts (Pt 1)
- Assets held for sale/
Discontinued Operations
- Mineral resources (Pt 1)
- FI disclosure
- Operating segments
- Financial instruments
 - Classification and
measurement
- Consolidations/Associates/JVs
- Fair value measurement

Not quite finalised

- Financial instruments
 - Impairment
 - Hedge accounting
- Revenue
- Leasing
- Insurance contracts (Pt 2)

(“The big four”)

Assessment of the Tweedie era

Pro's

- Big step towards global GAAP ...except the US
- Increased comparability
- Increased understanding arising from common language
- National GAAP has waned in most places
- Some real progress on technical subjects:
 - Share based payment
 - Acquisitions

Con's

- Standards now very complex (but IFRS for SMEs)
- US convergence has been problematical
- Diverse applications of IFRS
- IAS 39 still with us
- The big four projects not finished
- Political pressure, including high level of US influence

How might the IASB's work progress?

Agenda consultation – July 2011

Maintaining existing IFRS

- Post-implementation reviews
- Interpretations/ implementation problems

Developing financial reporting

- Updating framework
- Researching strategic issues
- Finalising big four and moving on to other projects

What specifics could be on IASB's agenda?

Revenue
Leasing
Financial instruments
Insurance
Conceptual framework
Financial statement presentation
Foreign currency
Income taxes

Emissions trading
Equity method
Interim reporting
Intangibles
Discount rate
Agriculture
Presentation and disclosures
Other comprehensive income

Inflation accounting
Debt/equity
Extractive industries
Liabilities/provisions
Government grants
Country-by-country reporting

Share-based payment
Islamic transactions
Rate-regulated entities
Business combinations – common control
EPS
Post-employment benefits

Early indications from the new regime

- Agenda consultation – first time
- Hans Hoogervorst is a politician – likely to have very different approach
- Ian Mackintosh is ex-UK ASB
- Likely to be less frenetic, more measured
- More emphasis on conceptual framework?
- Less emphasis on convergence with US?

Prospects for IFRS in the US

- Joint projects and joint board meetings have dominated 2000's
- US SEC most recent announcement in late 2011 – “we're still thinking about it”
- SEC staff already floated “condorsement” approach
- FASB almost certain to survive as the US standard-setter
- US likely to add their own interpretations
- What role will there be for joint projects (special relationship) in future?

New for 2011 and recently issued standards

2

New and amended standards/interpretations

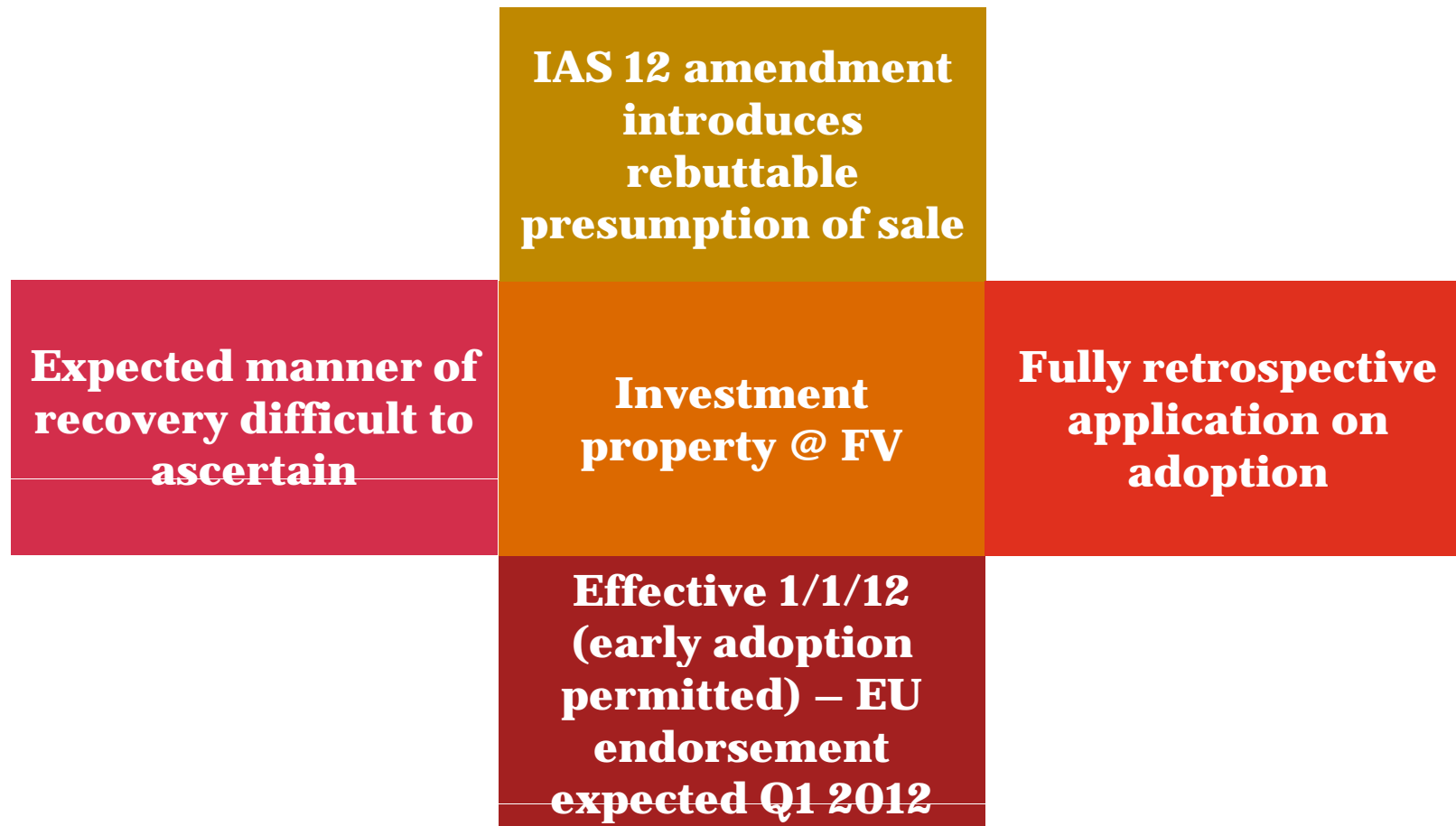
Effective for periods beginning on or after 1 Jan 11:

- IAS 24 (Revised) – Related Party Disclosures
- IFRIC 14 (Amendment) – The limit on a defined benefit asset
- Annual improvements (2010)

Standards to consider early adopting:

- IAS 12 (Amendment) – Income taxes

Amendment to IAS 12 deferred tax on investment property



What standards have been issued recently?

The major new standards and amendments issued recently are:

- IFRS 10 – Consolidated financial statements
- IFRS 11 – Joint arrangements
- IFRS 12 – Disclosure of interests in other entities
- IFRS 13 – Fair value measurement
- IAS 19 (amendment) – Employee benefits

Effective date for all is 1 January 2013
Once adopted by EU (expected in 2012) may early adopt

IFRS 10 – Consolidated financial statements



New consolidation standard – IFRS 10

- Changes definition of control; core principle unchanged
- Same criteria for all entities to determine control; no distinction for SPEs
 - Focus on power and variable returns before control is present
 - Voting or contractual rights are evidence of power
 - ‘De facto’ notion more firmly defined
 - Power is continually assessed
 - Intended temporary control does not prevent consolidation
- Effective date – 1 January 2013

Who will these changes affect?

Generally the changed definition of control will not affect the scope of consolidation for most corporates. The main impact will be felt by:

Investment managers

New guidance as to whether the manager exercises control as a principal or agent:

- Scope of decision making authority
- Rights held by other parties
- Nature of remuneration
- Exposure of the manager to variability from other interests

Entities with SPEs

SIC-12 is being withdrawn by IFRS 10 so entities with SPEs should revisit their consolidation decisions in light of the new guidance

Investment companies (ED)

Investment companies to be scoped out of IFRS 10

- Investment companies
 - Excluded from the consolidation standard
 - All investments (with limited exceptions) to be held at FV through P&L

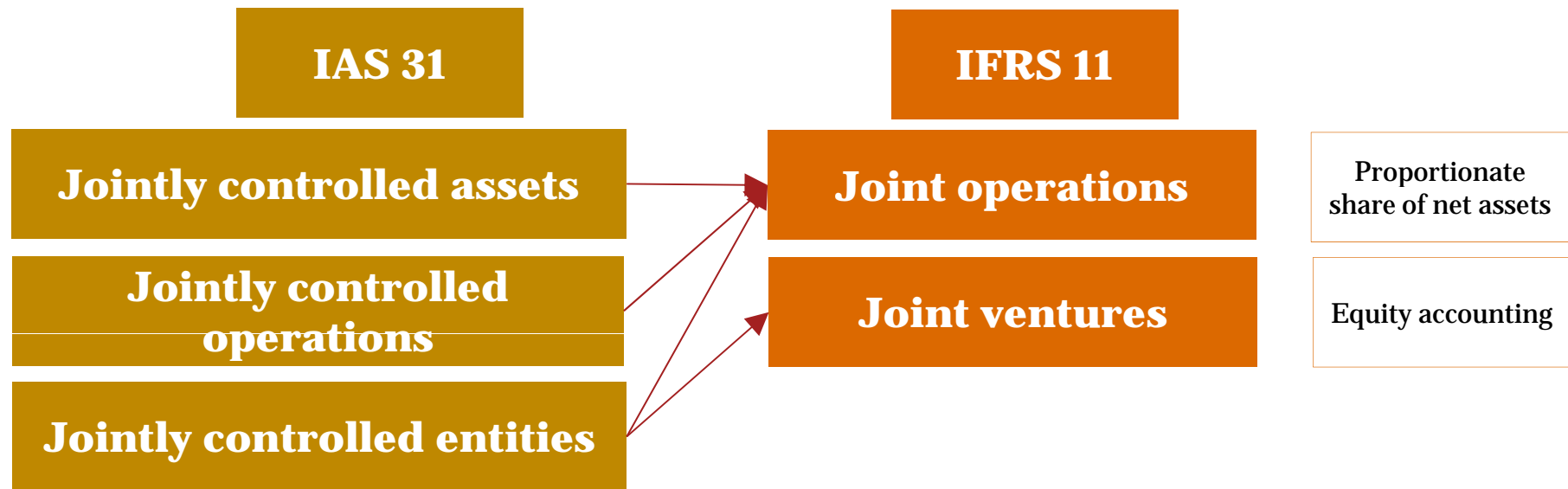
- ED published August 2011
- Comment deadline 5 January 2012

IFRS 11 – Joint arrangements



What are the changes?

- Greater emphasis on contractual rights and obligations:
 - Right to share in net assets → joint venture
 - Right to share in individual assets and liabilities of the joint arrangement → joint operation



IFRS 11 implementation challenges

Internal

- Reviews of joint arrangement agreements required
- Understanding complexity of contract is key
- Ongoing review of contractual agreements and application of judgment are required

External

- Will users of the financial statements understand changes?
- Financial ratios and metrics – covenant breaches?
- Potential tax impacts
- For investments in joint ventures, loss of ability to report gross revenues

IFRS 12 – Disclosure of interests in other entities



IFRS 12 – Disclosure of interests in other entities

**IFRS 12 is a
disclosure only
standard**

**It consolidates (and adds to)
the disclosure requirements in
respect of subsidiaries, joint
arrangements, associates and
unconsolidated SPEs**

IFRS 13 – Fair value measurement



IFRS 13 – Fair value measurement

- Objectives
 - Provides single source of guidance for all FV
 - Clarifies fair value definition and related guidance
 - Enhances disclosures
 - Enhances convergence with US GAAP
- Codifies existing valuation practice
- No major changes expected in practice

- IFRS 13 issued in May 2011
- Effective 1/1/2013, earlier application permitted

IAS 19 (amendment) – Employee benefits



Defined benefit pensions

- Net finance costs likely to increase (see next slide)
- All actuarial gains and losses to be recognised immediately in OCI
- Other options to be abolished:
 - Corridor method
 - Recognition of actuarial gains and losses in P&L

Measurement changes

		Expected return / discount rate	Old Method	New Method
	£	£	£	£
Pension assets	800	8%	64	-
Pension liabilities	(1,000)	6%	(60)	-
Deficit	(200)	6%	-	(12)
Net income / (expense)			4	(12)

Termination benefits

Link to future service

- Redundancy payments linked to a required period of future service are not termination benefits
- These payments are post employment benefits and the cost is spread over the service period

Voluntary redundancy

- Provision cannot be made for an offer of voluntary redundancy if it can be withdrawn
- A liability is only recorded once an entity is committed

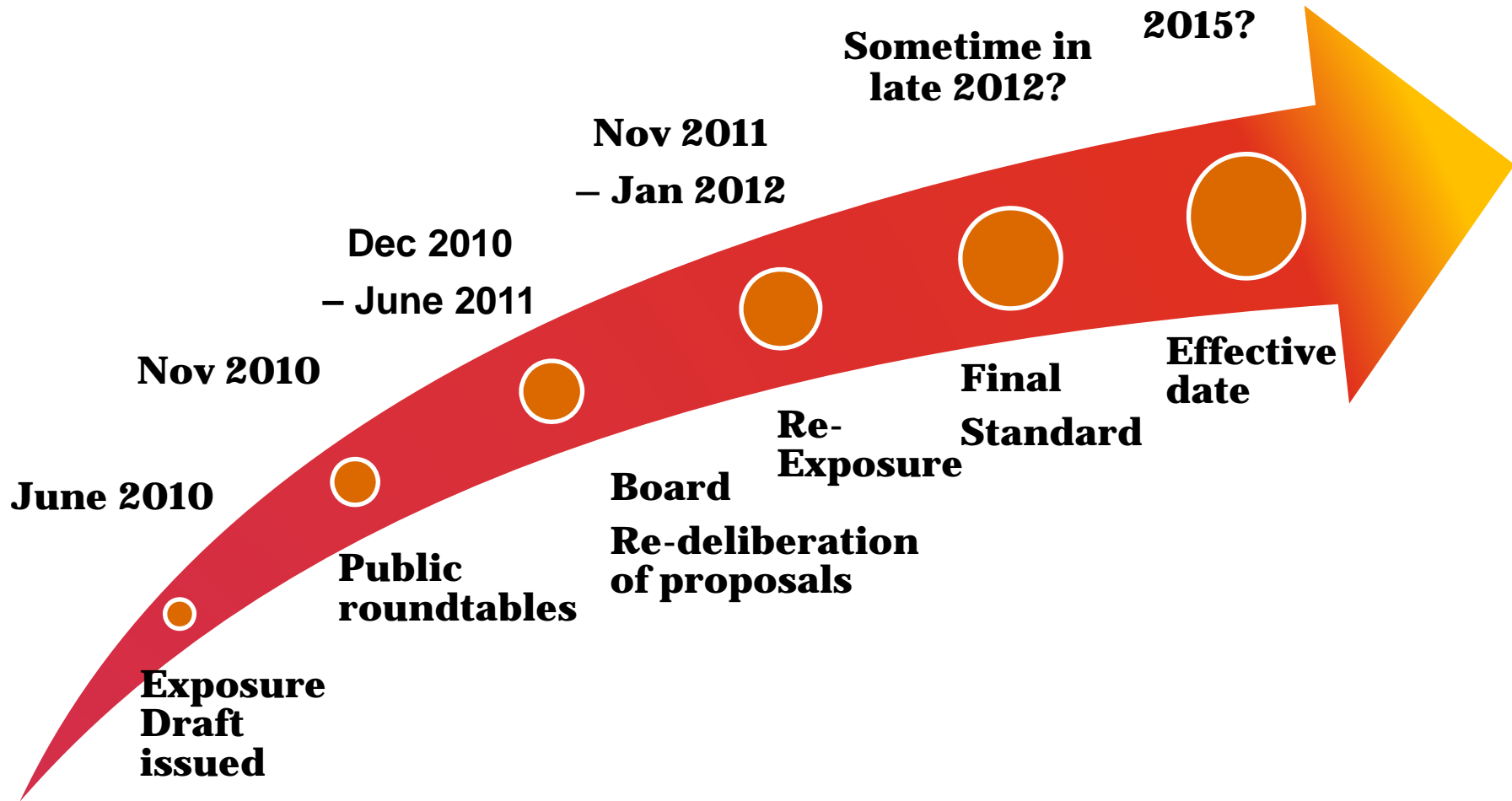
Significant IASB projects

3

Revenue



Revenue timeline



Revenue from contracts with customers

A single converged model for all revenue contracts

- Revenue recognised when control of goods/services passes to the customer
- Second Exposure Draft issued
- Comment period ends 13/03/12
- Effective date expected to be no earlier than 2015 with retrospective application

The 5-step model

- 1** Identify the contract(s) with the customer
- 2** Identify and separate performance obligations in the contract
- 3** Determine the transaction price
- 4** Allocate the transaction price to the separate performance obligations
- 5** Recognise revenue when each performance obligation is satisfied (transfer of control)

Revenue from contracts with customers

Key definitions

Performance obligation

A promise in a contract with a customer to transfer a good or service to the customer

Performance obligations are only accounted for separately if the risks associated with the provision of the bundle of goods and services are largely separable and each item is distinct.

The 5-step model

- 1** Identify the contract(s) with the customer
- 2** Identify and separate performance obligations in the contract
- 3** Determine the transaction price
- 4** Allocate the transaction price to the separate performance obligations
- 5** Recognise revenue when each performance obligation is satisfied (transfer of control)

Revenue from contracts with customers

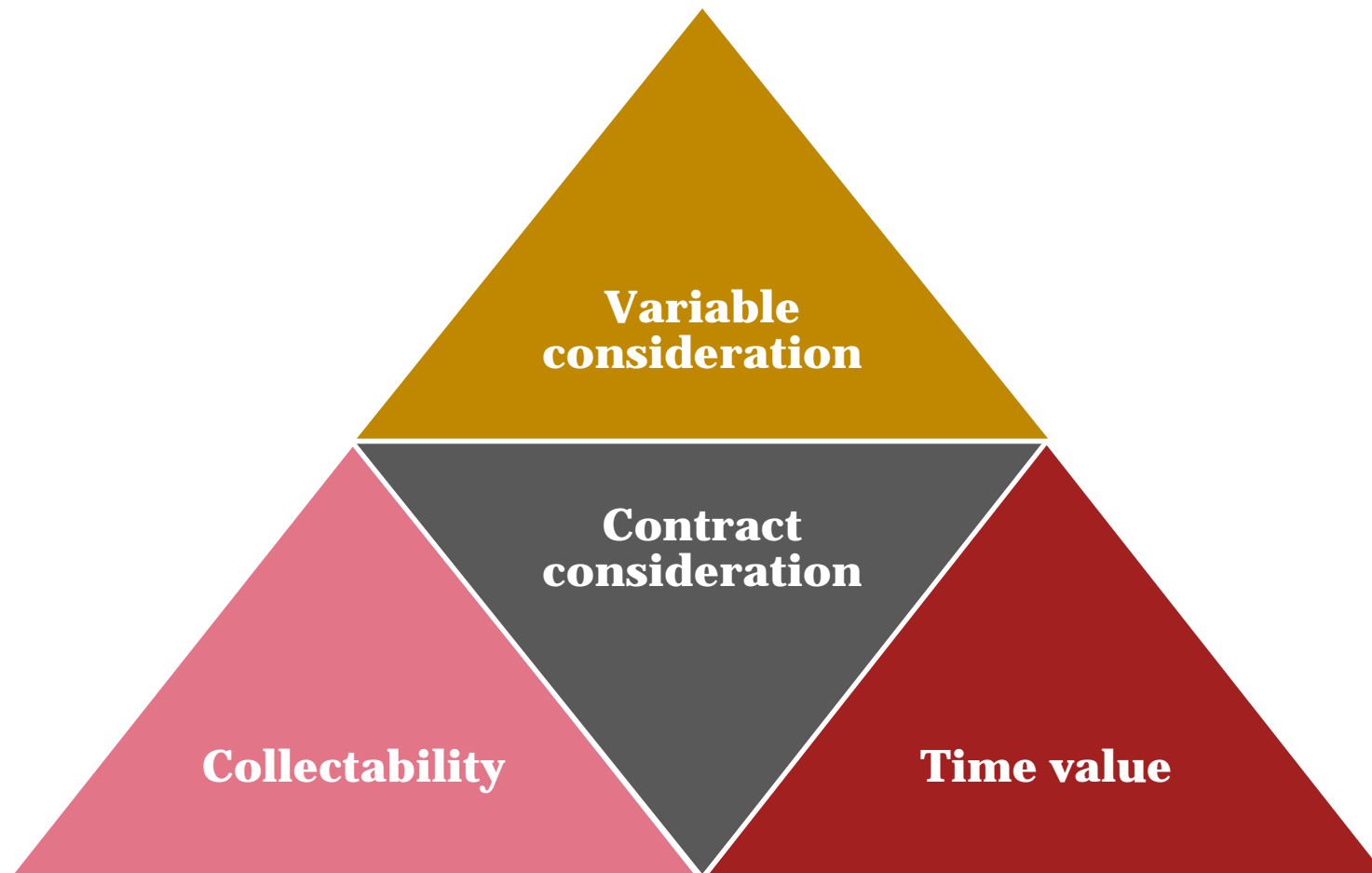
Key definitions

Transaction Price

The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, taxes).

Revenue from contracts with customers

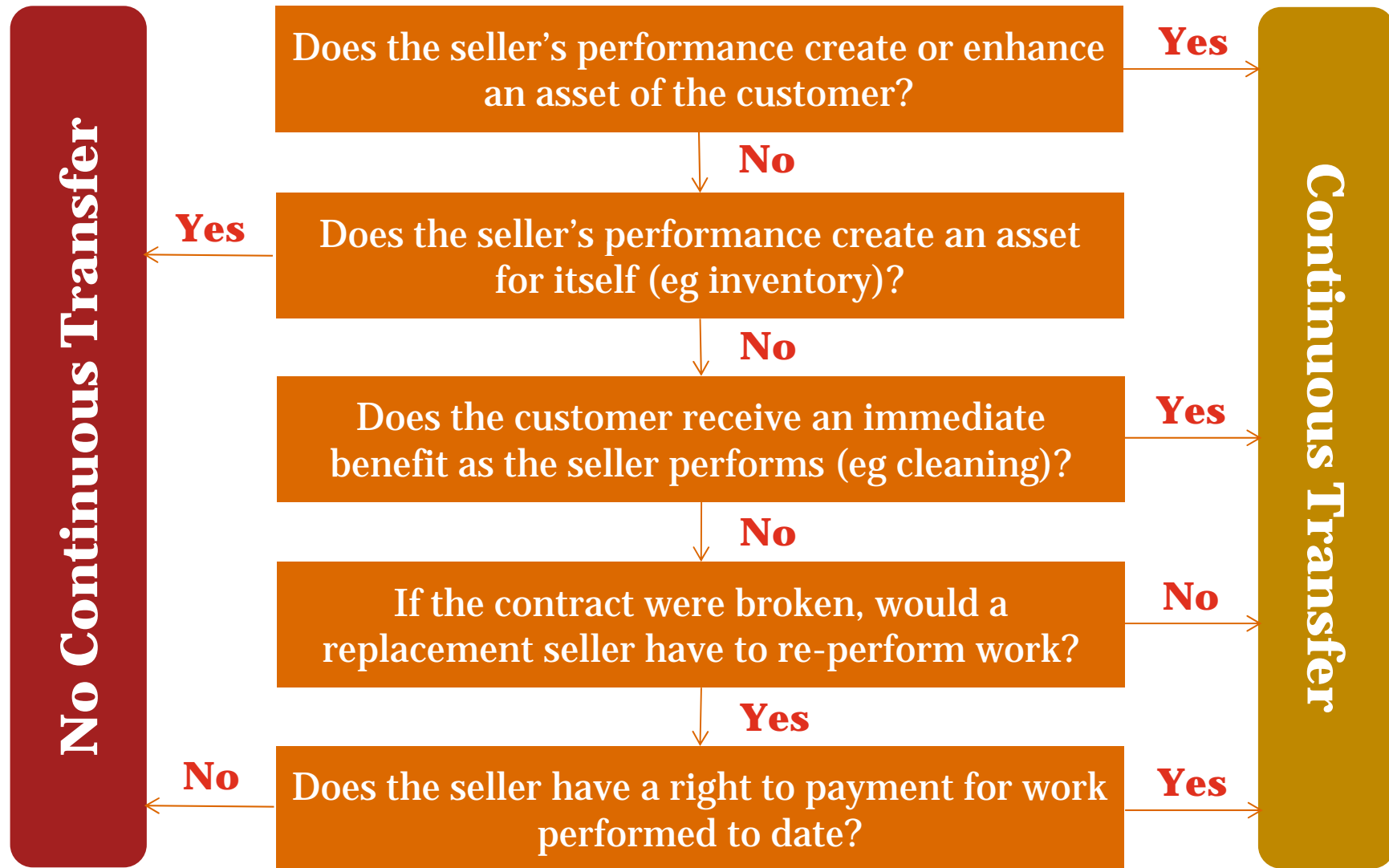
Key concepts



Five-step process for applying the model

- 1** Identify the contract(s) with the customer
- 2** Identify and separate performance obligations in the contract
- 3** Determine the transaction price
- 4** Allocate the transaction price to the separate performance obligations
- 5** Recognise revenue when each performance obligation is satisfied (transfer of control)

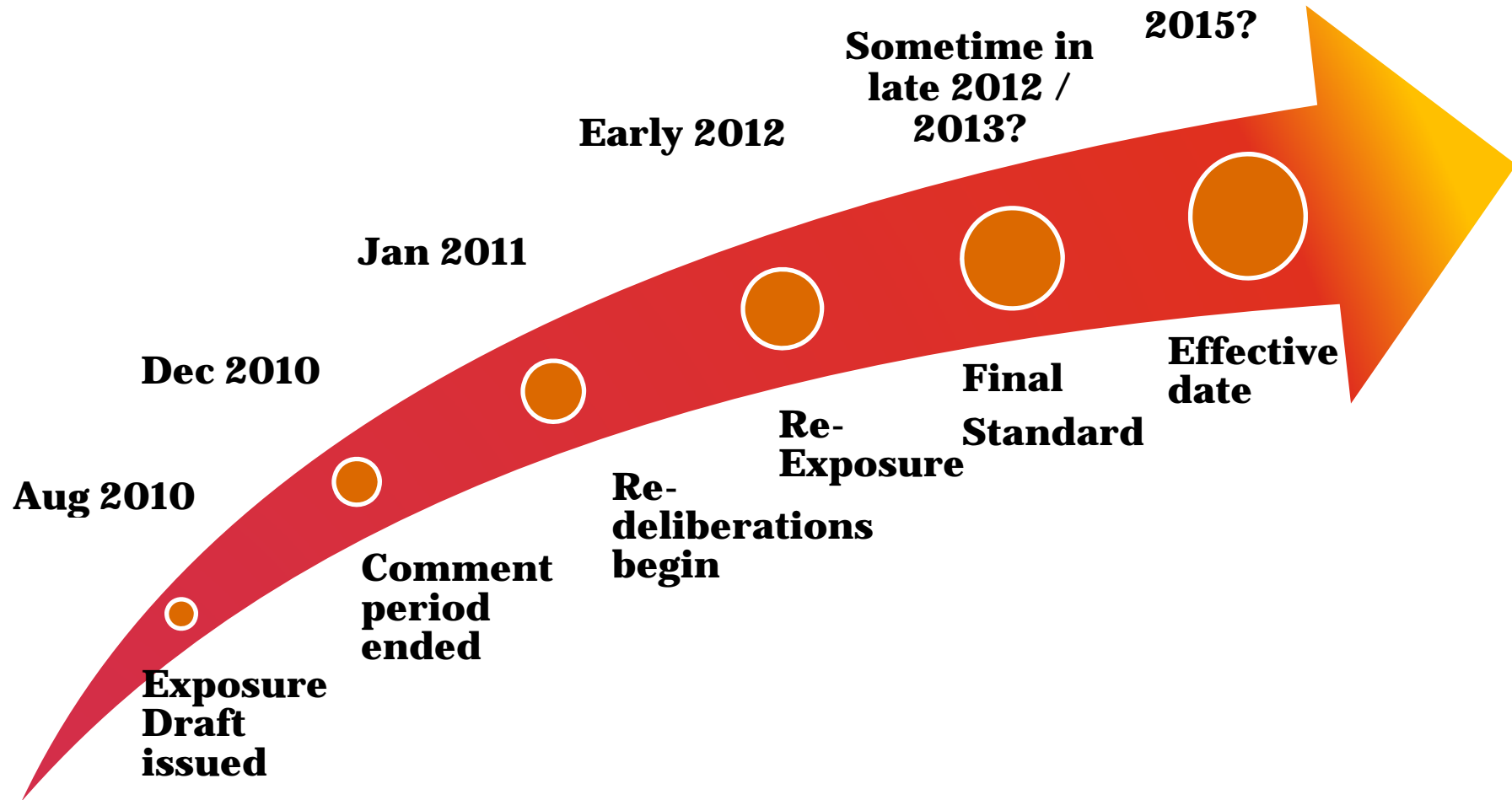
When does control transfer?



Leasing



Lease accounting overhaul

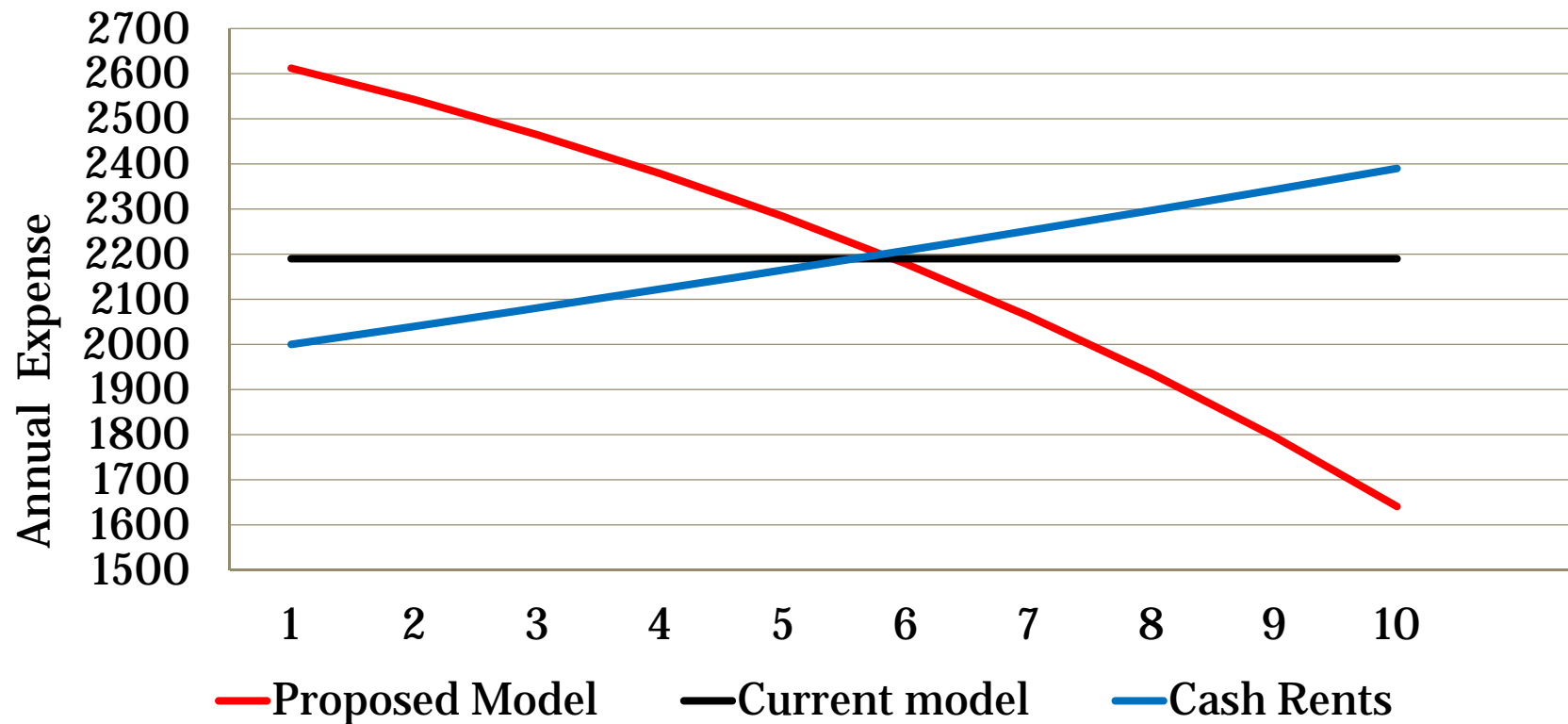


Summary of likely changes to lessee accounting

- All leases to be brought on balance sheet and treated the same:
 - Balance sheet has an asset and liability for all leases
 - P&L –expense recognition changes with front-loading and more volatility
- Contingent rentals based on a rate or index to be estimated
- Lease terms to include extensions where there is significant economic incentive to extend

Balance sheet	
Assets	↑
Liabilities	↑
Income statement	
Rent expense	↓
Amortization	↑
Interest expense	↑
EBIT	↑
EBITDA	↑
EBITDAR	≡
EPS	↕
Cash flow statement	
Cash from ops	↑
Cash from finance	↓

Impact of the proposed model



The chart above depicts the impact on earnings for a basic 10 year lease with an initial annual rent of \$2,000, a 2% annual escalation rate and an assumed incremental borrowing rate of 7%.

Some reactions about the ED and impacts

Reactions

- JP Morgan – “Bringing operating leases onto the balance sheet and changing the measurement basis of all leases has the potential to affect significantly the ratios and related quantities commonly used in investment decision making.”
- Credit Suisse – “\$634 billion in future minimum lease payments due under operating leases by the companies in the S&P 500”
- Standard & Poors – “Proposed lease-accounting requirements likely to affect our analysis”

	Average increase in interest bearing debt	Average increase in EBITDA
All companies	58%	18%
Retail and Trade	213%	55%
Accommodation & Food Services	101%	30%
Professional Services	158%	27%
Transport & Warehousing	95%	25%
Construction	68%	14%
Manufacturing	50%	13%
Financial services	27%	15%

Financial instruments



Financial instruments project timetable

Section	Next document	Publication date
Classification and measurement	IFRS issued	Assets – 12/11/2009 Liabilities – 28/10/2010
Impairment	Re-exposure	H1 2012
General hedging	Review draft	Q4 2011
Macro hedging	Exposure draft	H1 2012
Asset and liability offsetting	IFRS	Q4 2011

Effective date 2013 – 2015?

IFRS 9 – Classification of financial assets

Equity investments: Always held at fair value (FV) but elect as FV through P/L or OCI

Debt investments: New tests for assessing categories (business model and cash flow characteristics)

Impact for non-FS companies:

- AFS has gone
- No need to separate embedded derivatives from assets
- Cost exemption for unquoted equities removed

IFRS 9 – Classification of financial liabilities

- **No change except for fair value option**
- **Assets and liabilities are not symmetrical**
- **Limited impact on non-FS companies**

IFRS 9 – General hedging

The review draft due out in Q4 2011 improves hedge accounting in a number of key areas...

***Risk components
of non-financial
items***

Net positions

***Use of options
for hedging***

***Hedge
effectiveness
testing***

***Aggregated
exposures***

Impairment – why a new model?

**Expected loss
(Proposals)**



Incurred loss (IAS 39)

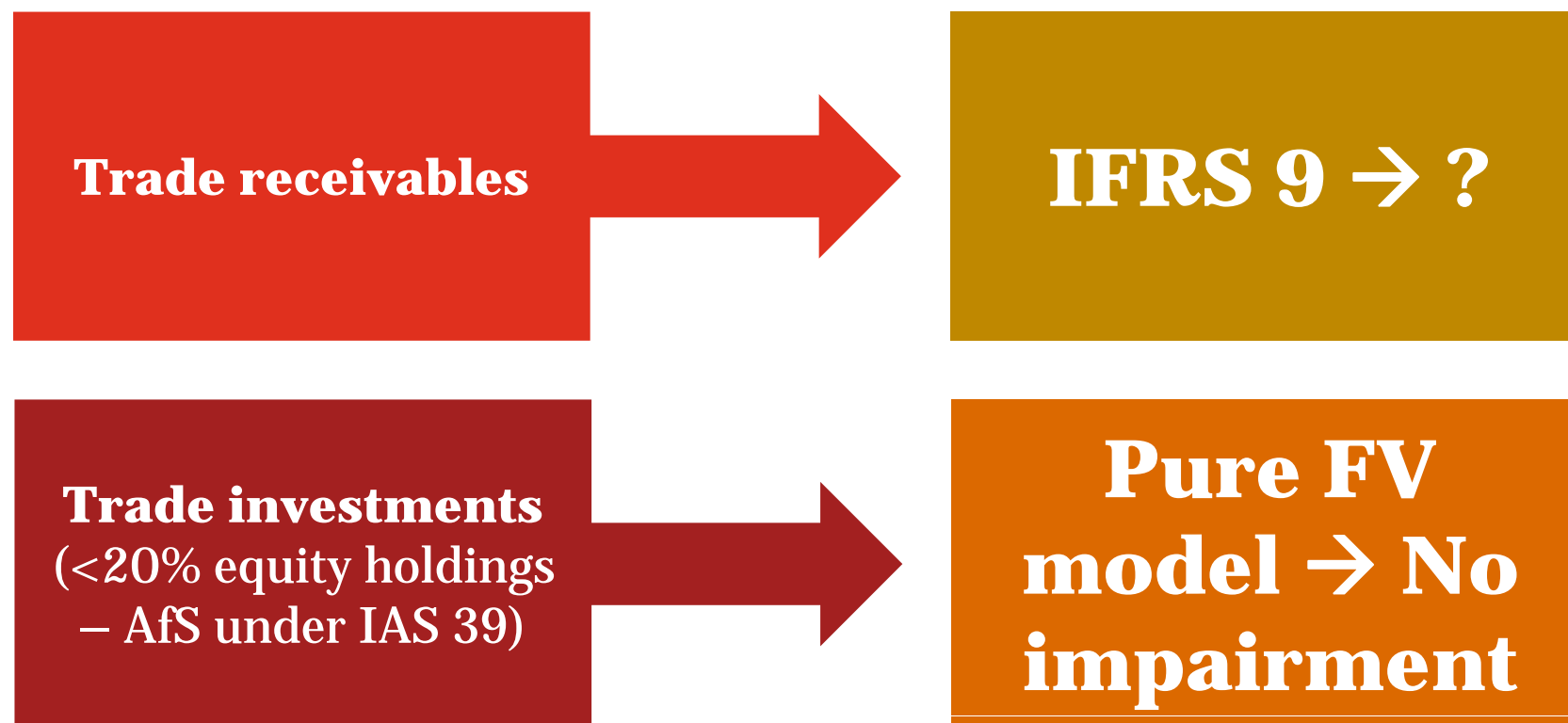
**Forecast increase
in unemployment
rates**

**Increase in
unemployment
rates**

**Default on
payments**

How will this affect corporates?

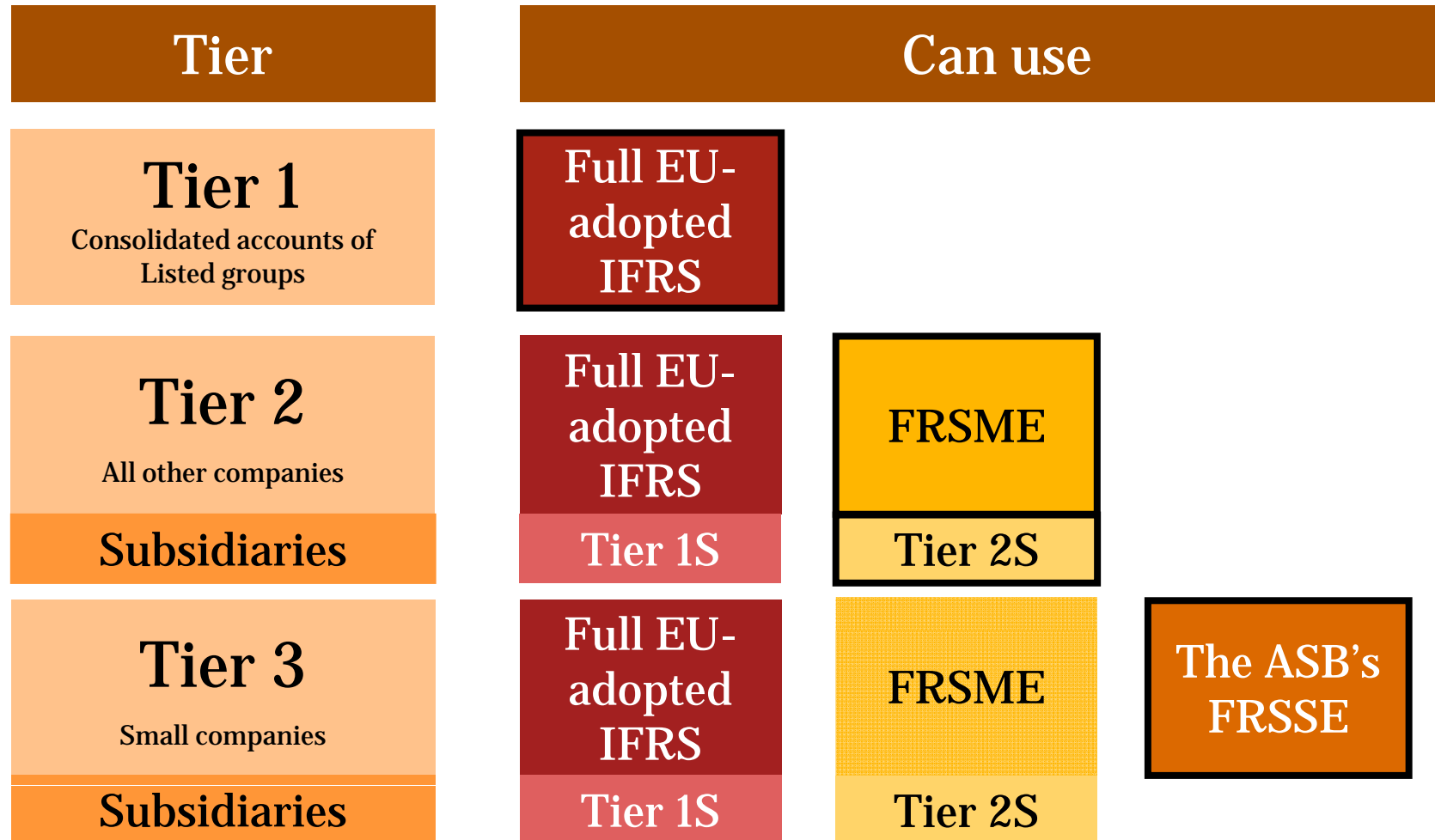
What types of financial asset do corporates have today that are subject to impairment?



The future of UK GAAP

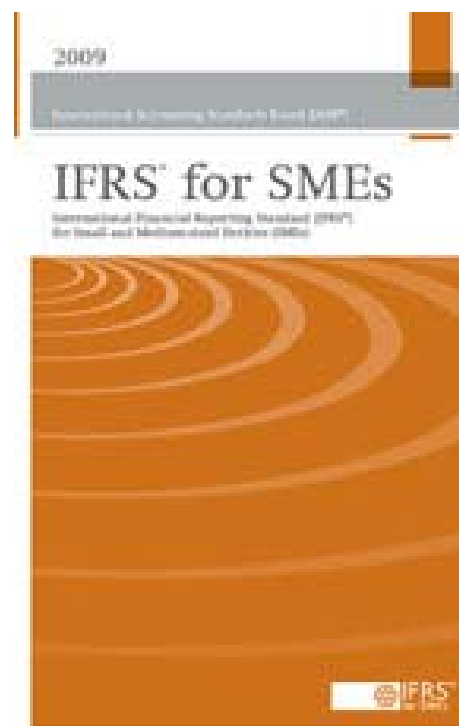
4

ASB proposals

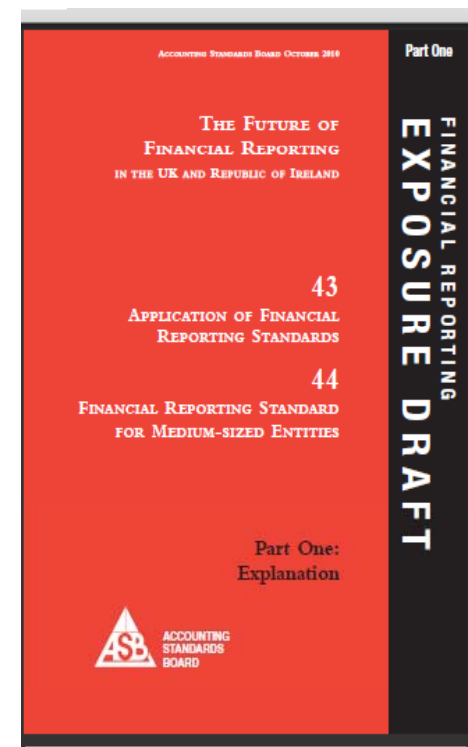


Why is the FRSME different to the IFRS for SMEs?

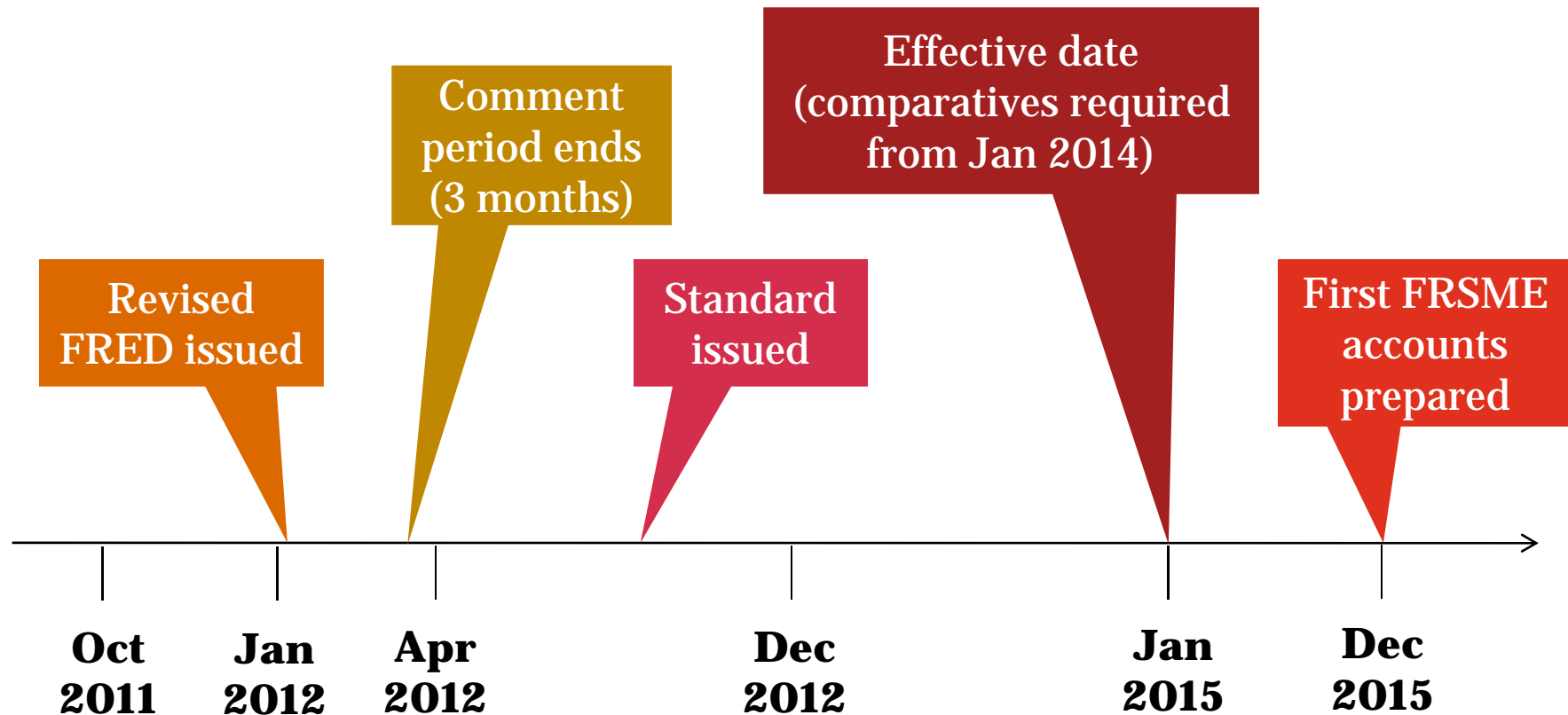
- 1. EU directives** – The FRSME is UK GAAP so must comply with EU directives
- 2. Practical changes** – The IFRS for SMEs prohibits certain treatments required by IFRS
- 3. Different scope** – Now that certain publicly accountable entities will be using the FRSME, additional guidance and disclosure is required



VS



What next?



FRRP activity and hot topics

5

Who are the FRRP?

- Established as part of the FRC
- Review annual reports of public and large private companies
- Compliance with law and accounting standards

How do they work?

Selection of accounts:

- risk based approach
- select from certain industries
- complaints from the public
- qualified audit opinion

Consultation on operating procedures

- Share info with AIU
- Reserve right to make announcements following a significant change by a company
- Ability to comment when enquiry becomes public knowledge

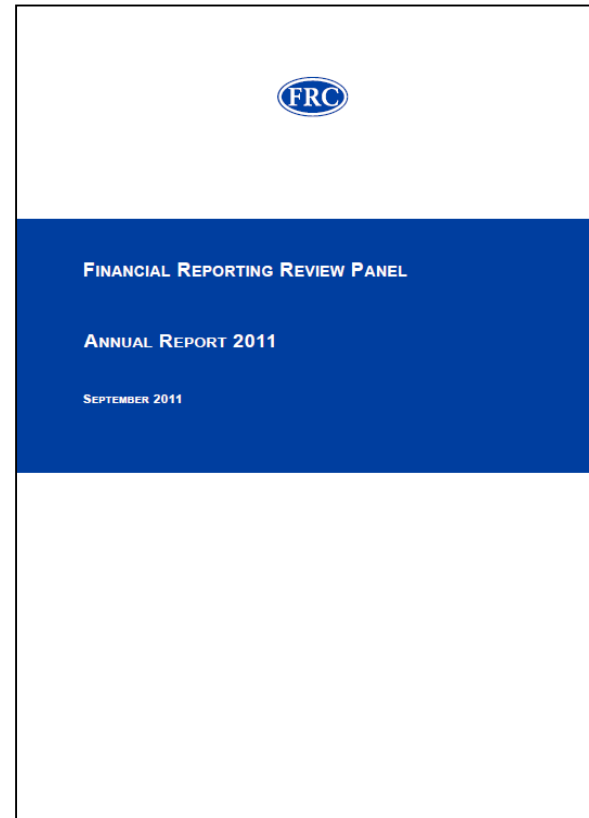
2011 Annual report

Annual activity report-for year to March 2011

268 Selected by the FRRP

33 complaints/referrals

- 301 sets of accounts reviewed
- 141 companies approached by Panel (47%)
- 4 companies subject to a Press notice



FRRP – 2010/11 Annual Activity Report

<u>Targeted reviews</u>	<u>Key findings</u>
<ul style="list-style-type: none">• Director's reports (Business Reviews)• Capital Management disclosures• Half yearly financial reports	<ul style="list-style-type: none">• Accounting policies - particularly revenue• Judgements and assumptions• Statement of cash flows• Income taxes• Impairment of assets• Operating segments

FRRP comments – Accounting policies

“As in previous years, most substantive questions about accounting policies related to aspects of revenue recognition, often triggered by policy descriptions in the accounts that were entirely generic, usually borrowing words direct from accounting standards, and that therefore did not explain the policy in terms of the company’s particular business model and transactions.”

“The Panel challenged a number of companies where it appeared from the description of their accounting policy that revenue might be recognised in the income statement before the qualifying criteria had been satisfied, leading to an overstatement of income.”

“With this exception, overall, the Panel considered the summaries of accounting policies provided to be of good quality.”

FRRP comments – Judgement/Assumptions

“IFRS is a principles-based reporting framework which requires management judgment in its application. The Panel continued to challenge companies that maintained there were no areas in which the Board had exercised significant judgment that had a significant effect on amounts recognised in the financial statements.”

“The Panel remains of the view that more could be done to improve the quality of sensitivity disclosures required where a reasonably possible change in a key assumption could give rise to a change in the amounts reported.”

FRRP comments - Cash flows

“Two press notices were published in the year in respect of companies both of whose operating cash flows were materially understated.”

“The Panel’s enquiries were often prompted by an apparent inconsistency between matters reported in the cash flow statement and elsewhere in the report and accounts – often disposals of operations or plant, property and equipment.”

“Cash equivalents are short-term highly liquid investments that are readily convertible to known amounts of cash. The Panel continued to challenge companies who appeared to adopt a different definition by including bank loans or longer term deposits, obscuring the real short term position.”

FRRP comment – Impairment of assets

“If the company has CGUs with disparate activities, the Panel will generally question the application of a single discount rate to the testing for impairment of all CGUs.”

“Where a material impairment loss has been recognised or reversed, the standard requires disclosure of the events and circumstances leading to that event. There were a number of instances where this explanation was either lacking, generic or positioned outside the IFRS accounts without an appropriate cross-reference within the audited financial statements.”

“The Panel notes that there is no exemption from disclosure in the standard on grounds of commercial sensitivity.”

FRRP comment – Operating segments

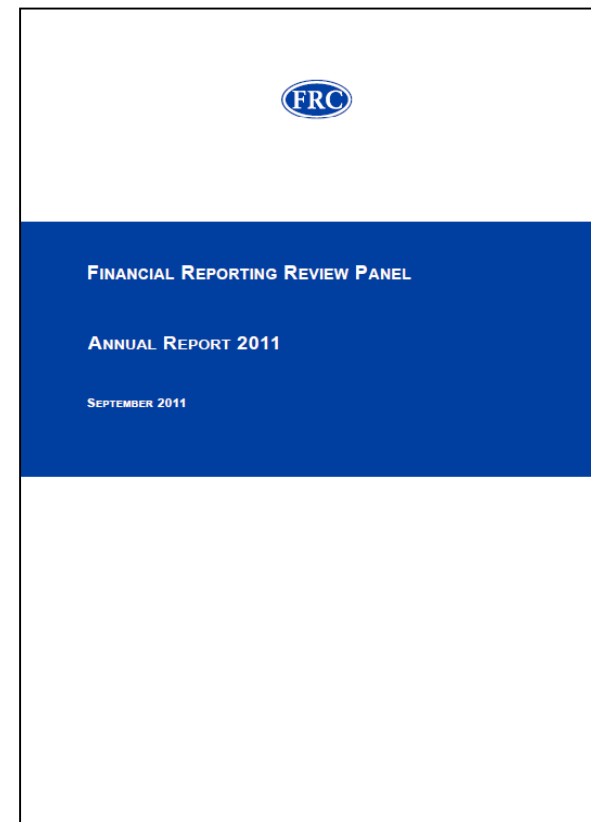
“Questions put to companies by the Panel during the year were often prompted by apparent inconsistencies between the narrative reports and the audited accounts. The Panel continued to challenge companies that appeared to have aggregated operating segments where it was difficult from the information provided to appreciate the sense in which the segments were economically similar as required.”

“The Panel also observed a failure by many companies to disclose the entity-wide information required by the standard, which relates to information about products and services, geographical areas and major customers. “

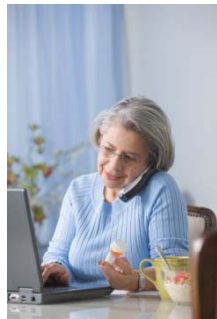
Is this “A good set of Report and Accounts”?

Characteristics of corporate reporting which the FRRP believe make for a good annual report.

- A single story
- How the money is made
- What worries the Board
- Consistency
- Cut the clutter
- Clarity
- Summarise
- Explain change
- True and Fair



FRRP priority sectors for 2011/2012



**Support
services**



**Commercial
property**



**Priority
sectors
2011/2012**

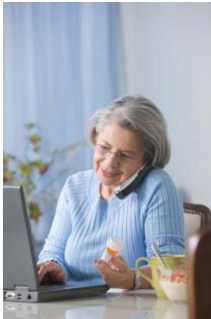
Insurance

Travel



Insurance

FRRP's priority sectors for 2012/2013



**Support
Services**



**Commercial
property**



Retail

**PRIORITY
SECTORS
2012/2013**

Focus on:

- Reporting of risks and uncertainties
- Where shareholders have raised concerns about governance
- Are business reviews fair and comprehensive

CRUF – what the Users think

Some quick wins

- Segment information
- Net debt reconciliation
- Debt – maturity and terms
- Cash disclosures
- M&A activity
- Pensions

Thank you

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